104

ESTATE TAX REFORM AND THE FAMILY BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, January 31, 1995

Printed for the use of the Committee on Small Business

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ESTATE TAX REFORM AND THE FAMILY BUSINESS

TUESDAY, JANUARY 31, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in Room 2359–A, Rayburn House Office Building, Hon. Jan Meyers (chairwoman of the committee) presiding.

Chairwoman MEYERS. Ladies and gentlemen, good morning.

Continuing our series of hearings devoted to tax policy and small business, this morning, we will be focusing on the estate tax and the family business. As you know, estate taxes are a critical issue for many small businesses in this country. The continuity of a business into the second and third generation of a family is not only vital to our economy but an important aspect of American society—building something for our children and for their children. Section 12001 of H.R. 9, the Job Creation and Wage Enhancement Act, increases the unified estate and gift tax credits. These provisions would reduce the disastrous results of taxes on family-owned businesses.

As you know, the current estate tax exemption is $600,000, which means that up to $600,000 of the wealth owned by a decedent at death is not taxed under the estate and gift tax provision. This $600,000 exemption is equivalent to a unified estate and gift tax credit of $192,800. However, enacting the provisions in the Contract With America would not only increase the estate tax exemption from the current $600,000 amount incrementally to $700,000, $725,000, and $750,000 in 1996, 1997, and 1998 respectively, but also beginning in 1998, the $750,000 would be adjusted for inflation.

The unified transfer tax credits for these exemption levels would equal $229,800 in 1996, $239,000 in 1997 and $248,000 in 1998. The contract's proposal would reduce the number of estate tax returns, but not significantly. Regardless, the proposed tax relief may not reach those estates more likely to have liquidity problems, therefore many times forcing family members to sell their business assets to pay the estate tax.

I strongly support the provisions in the contract and believe it is a good start to protecting the lifetime investments of the small business family and reducing the estate tax burden overall. I look forward to your testimony.

[Chairwoman Meyers's statement may be found in the appendix.]

Chairwoman MEYERS. At this time, I would like to recognize Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Madam Chair.

I am pleased that we are having this last hearing on some of the provisions of the contract for America. The whole question of the estate exemption tax is a very important one. It has long been a concern of mine. Indeed, in earlier Congresses, as Chairman of the Small Business Committee, I introduced legislation to increase the amount of the exemption and also to index it for inflation. But I did so aware of the potential problems.

Whenever you become involved with inflation, automatic indexation, you create a whole host of potential problems because there are so many things that you could index. If you only index one thing, it might throw everything else out of balance. For example, what do you do about capital gains and what do you do about ordinary income? Are we going to have an automatic indexation of the minimum wage, et cetera? So you have to be very careful with the concept of indexation.

However, if you believe in the basic premise of the exemption, at the very least, you need periodic review of what the appropriate amount should be in an attempt to accommodate inflation and at least retain the real value of the exemption.

I believe that since the last time the exemption was increased—I think this took place in 1987, based upon the 1981 law, which phased in increases to the exemption, ending at the $600,000 level in 1987—inflation has diminished the real value of $600,000 today to I think in the vicinity of about $464,070 in 1974, and $450,000 or so in 1995 dollars. So it is altogether appropriate and, indeed, necessary that we look at it at this point in time.

On the other hand, there are so many other provisions of the Tax Code that also need to be looked at from that perspective. It is almost impossible to look at one without the other: The personal exemption, earned income tax credits, you name it. You can't do this without considering the impact it is going to have upon revenues and, therefore, on deficit reduction.

So the challenge of the whole Congress is not to look at any one item in isolation but to make sure that this item is reviewed with a full consideration of U.S. tax and fiscal policy. I know this panel will have a very narrow perspective, but it is necessary to have that. I hope at some point in time we can have a broader perspective embracing the totality of those issues.

Thank you.

Mr. MANZULLO. Madam Chairman.

Chairwoman MEYERS. Yes, sir.

Mr. MANZULLO. I would ask for leave to file a statement.

Chairwoman MEYERS. Yes.

All those who would like to file opening statements for the record, without objection, permission is granted.

[Mr. Manzullo's statement may be found in the appendix.]

Chairwoman MEYERS. Is Mr. Robert Spence here?

Mr. SPENCE. Yes, I am.

Chairwoman MEYERS. All right.

Mr. Bracewell?

Mr. APOLINSKY. No. I am Apolinsky.

Chairwoman MEYERS. All right.
Mr. Bracewell.
Mr. BRACEWELL. Yes.
Mr. LAFALCE. Madam Chair, can I just ask something?
The sheet doesn't indicate, can we know what organizations they represent?
Chairwoman MEYERS. I will say that.
Mr. Lee William McNutt joins us from Corsicana, Texas, where he is president and CEO of Collin Street Bakery. He is also a member of the National Federation of Independent Business.
Mr. LAFALCE. But is he representing the NFIB today?
Chairwoman MEYERS. I am sure he is speaking for himself.
Mr. MCNUTT. I am speaking personally, but in support of their position.
Mr. LAFALCE. Well, I just think it is important to understand that we are having the testimony of the NFIB. I think that is true for virtually all of the other witnesses. I think it would be helpful if on the witness list we put down the organization that has been asked to prepare their testimony and have them testify, so we realize who it is. If it is the NFIB, fine.
I have tremendous respect for the NFIB and a close working relationship with them from the first day in Congress to the present. But it is nice to know that. The witness lists have been omitting that. I think it would be helpful.
I think, for example, every day we have had the NFIB, every day the National Small Business Council of America, National Small Business United, et cetera, et cetera. If we don't have that information listed, we don't realize that.
Mr. MCNUTT. That statement is largely their work. However, their—my remarks are totally my own and totally independent.
Mr. LAFALCE. I understand that. But when I see testimony of the National Federation of Independent Business, I would like to see that on the witness list in the future.
Chairwoman MEYERS. Mr. McNutt, as I understand it, you are submitting this statement from NFIB, but you will be making your own remarks?
Mr. MCNUTT. That is right.
Chairwoman MEYERS. Is that right?
Mr. MCNUTT. I am supportive of the statement, but will be making my own.
Chairwoman MEYERS. Yes.
At each panel we have announced which group the individual is representing, and after this, we will put it on the witness list.
Mr. McNutt.

TESTIMONY OF LEE WILLIAM McNUTT, JR., PRESIDENT, COLLIN STREET BAKERY, CORSICANA, TEXAS

Mr. MCNUTT. Thank you.
Am I all right?
Chairwoman MEYERS. Thank you. Speak directly into it, because they are directional mikes.
Mr. MCNUTT. I am William McNutt Jr., Bill McNutt, if you will, and I am president of Collin Street Bakery in Corsicana, Texas. What is Collin Street Bakery? We are a family-owned, single-prod-

uct business, now in its 99th year of doing business. My father and uncle bought Collin Street Bakery in 1946 from the widow of its founder, at which time it was in its 50th year. It is now in my family 49 years.

Our only product is a beautiful and marvelous fruit cake, a deluxe fruit cake that we market worldwide exclusively via direct-mail marketing. Never sold in stores. We have 400,000 active buyers who buy our cake primarily at Christmas time as a gift. So we are a niche, highly seasonal business.

My family's business began with my father going stone broke back during the Depression, along with millions of other Americans. He began rising from the ashes in 1933 with an $800 investment in a business in Corsicana, Texas, the money having come from a $1,200 inheritance that my mother received from her father who passed away in 1932. He was a small farmer. The remaining $400 of the $1,200 was invested in the purchase of a home.

From that humble beginning 62 years ago, has emerged a success story that is very typical of the American entrepreneurial spirit, combining sometimes back-breaking work with determination, with industrious employees, good people, a marvelous product, slow and steady growth has taken place now into its third generation.

Chairwoman MEYERS. Mr. McNutt, I wonder if I could ask you to summarize your testimony because we have two full panels and I want to make sure——

Mr. MCNUTT. Absolutely.

Chairwoman MEYERS. That we get all the way through your testimony.

Mr. MCNUTT. Absolutely.

My father passed away 23 years ago. We have enjoyed since that time a tremendous growth. Not only have our domestic sales risen nicely, but our foreign sales, export sales have gone from 0 to 25 percent of our total volume, which we are very proud.

We have been recognized by the Department of Commerce with the Presidential Award for Excellence. During these last 23 years, our employment has risen from 24 to over 85 people, and we employ 650 people seasonally, making us the most important employer in our community of 23,000 people.

I have steadfastly resisted several attempts of larger companies to acquire Collin Street Bakery. I have done so for a couple of reasons, one being that I just know that our company and its customers can best be served as a family-owned operation because it requires a lot of tender-loving care.

The second reason is an obvious wish to pass along the business to the third generation. My heir apparent is a 38-year-old son who began working summers when he was 12, he would go with me at 8:00, sweep the curbs around the bakery and has since worked in every phase of the operation and is very able and very dedicated.

Now, nearing 70 years old, after 37 years with Collin Street Bakery, I am about ready to pass the baton. Since my ownership of the bakery comprises well over one half of my total assets, the selling of everything other than the bakery stock that I have—that I own, couldn't cover the taxes.

I have written memos to my children to be read upon my death and telling them that if they wish to keep the company—and I

know that they would love to, they are very sentimental about it, its history and one thing or another. I said, sell everything your parents own. Sell your mother's jewelry. Sell whatever art we have. Sell our homes. Be sentimental about nothing and you might raise enough money from that, combined with a loan, that you might be able to afford to keep the business. I don't know. It would depend on the circumstances at the time.

Who really owns Collin Street Bakery? Well, I am the majority owner. Yet the Federal Government is the real owner or controlling owner with 55 percent of the ownership that it gets through estate taxes. The last few years, I have not taken risk. I have not tried really to build the business but just to manage the business. Why should I? For what purpose? Just to have more swept away through onerous and confiscatory estate taxes.

Ms. Chairman, you and your committee really have an historic opportunity to reverse a 40-year drift in socialism and redistribution of the wealth. An historic opportunity. By backing tax policies and, in this case, allowing small businesses to be transferred from one generation to another, I pray that you will earnestly consider recommending not only the position that is in the Contract With America of raising it to $150,000—don't misunderstand, that will help. But it really is just tinkering. If you can find it amongst yourselves to recommend that small businesses under whatever reasonable terms, be exempt from estate taxes, you will have gone to long way toward serving and saving entrepreneurialship in the United States.

Thank you very much for being so attentive to my views and I will be happy to entertain any questions.

Chairwoman MEYERS. All right. Thank you very much for being with us this morning, Mr. McNutt.

[Mr. McNutt's statement may be found in the appendix.]

Chairwoman MEYERS. Mr. Diemer True.

Is it Diemer?

Mr. TRUE. It is, thank you.

Chairwoman MEYERS. Mr. True is a partner and shareholder in the True Companies, a group of family-owned oil and gas exploration and development companies headquartered in Casper, Wyoming. He is here today representing the U.S. Business and Industrial Council.

Mr. True.

TESTIMONY OF DIEMER TRUE, TRUE COMPANIES, CHAIRMAN OF THE BOARD, U.S. BUSINESS AND INDUSTRIAL COUNCIL

Mr. TRUE. Madam Chair, thank you, and what a privilege it is for me to be here. By way of an explanation on my remarks, I did draft my remarks and they have had the input of the USBIC, but they are generally generated out of my office.

Our business was founded in 1948 by my father. Dad was the consummate entrepreneur. He started planning 40 years ago for the succession of ownership and the succession of management. What I represent today is both what can be done right with planning in a family business and then also what the problems are.

Dad passed away in June of last year. He had actually been to his office that morning at the age of 79 and had already been at

work, literally worked up to the last minute. First of all, my three brothers—or the three brothers of us, my two brothers and I, have been in the business for over 20 years each. So we have the expertise and knowledge that goes with running an oil and gas business. But in addition, dad and mother started planning 40 years ago. The element that I would like to add to the discussion, a discussion, by the way, I am so grateful you are having, is a relook at the intergenerational aspect of buy-sell agreements.

Right now, as my brothers and their wives and my wife look at the third generation, our children are adults. Several of them have expressed an interest in coming back into the family business. As the law stands now, there is not a practical way to bring them back into the business as dad did with the three brothers of us.

There are three problems, as I see it. First, is the steeply graduated and high-marginal tax rates, which Mr. McNutt has already identified. Our businesses are like so many other family businesses. Our assets are not liquid. We would literally have to liquidate the businesses in order to pay a 55 percent tax rate.

Second, is the cumulative effect. Every 20 or 30 years in a family business, to have to retreat the size of the business by 55 percent, seems to me counterproductive in a global environment where literally we are out competing all around the world, with businesses around the world.

Third is, the complexity of the code. It is almost inevitable that any kind of sizable estate of a family-owned business ends up in litigation, and if I could make any suggestion as you look at different changes in the estate Tax Code, if you would look as an essential element to simplify the code, that would be most helpful.

Chairwoman MEYERS. Mr. True, some of us will have to leave just for a moment to vote in committee, and we will return almost immediately.

Will you proceed, and Mr. Torkildsen will take over the chair?

Mr. TRUE. Thank you, Madam Chair. I certainly understand.

Mr. TRUE. Besides simplification, I would ask that the committee revisit the whole issue of intergenerational buy-sell agreements. It has a number of aspects that are very, very helpful in closely-held businesses such as ours. It allows for planning. Right now, there is not a practical way for us to plan for the next generation's ownership or management.

In 1984, my sister withdrew from the business. The advantage of our buy-sells which were created beginning in the 1950's, was she knew at that point the basis upon which she would withdraw. There was a value established in the buy-sell agreements. So the acrimony that is so common and so widely reported as family businesses sometimes separate, there was none of that. We knew ahead of time. She knew ahead of time. It was a rational parting of the waters. She is still very much a part of our family. She just is not a part of the family business.

Please consider, as mentioned earlier, an increase in the unified credit. That would be very helpful to Main Street America and small businesses around the country. I think, if you look around the world at other countries and the estate tax rates, I think it would be reasonable to contemplate reducing the rate. Now, what that magic number is, I don't know. Ireland is 2 percent. Australia

is 0. Canada has a capital gains tax at death rather than an estate tax. I don't know what is appropriate. But breaking up of economic units just because they are families, just makes no sense to me. So I would hope that you would consider that.

I hope that perhaps you would consider expanding the applicability of the deferred payment provision and extending the 4 percent tax rate. That would be very helpful if you don't eliminate the tax altogether.

Those are my remarks. As I say, it is really a privilege to be here. I am most grateful to be here. I am most grateful that you are undertaking this project.

Thank you, Mr. Chairman.

Mr. TORKILDSEN. [Presiding.] Thank you, Mr. True.

[Mr. True's statement may be found in the appendix.]

TESTIMONY OF HAROLD APOLINSKY, SIROTE & PERMUTT, BIRMINGHAM, ALABAMA

Mr. TORKILDSEN. Our next witness is Harold Apolinsky, a practicing tax attorney, specializing in estate planning and probate. He is an active member of the Small Business Council of America, serving as vice president for legislation and is a past chair as well. Mr. Apolinsky.

Mr. APOLINSKY. Thank you very much. I appreciate the opportunity to share some thoughts with you.

For over 30 years, I have been a practicing tax lawyer. For the last 25 years, I have specialized in the field of estate planning. I assist clients in developing wills and trusts. When someone dies, I assist the widow or widower in filing the estate tax return.

For over 18 years, I have taught estate and gift taxation and estate planning at both the University of Alabama School of Law and the Cumberland School of Law in Birmingham, Alabama. I agree with some of the comments that have been made. This is an historic occasion.

I have brought along with me two friends who will not have an opportunity unless you ask questions to share their views. On my left in the front row is Mr. John Harbert and Mr. Hall Thompson, who are owners of significant family businesses and farms in Alabama. They are not clients of mine. They are not paying me to come here. This is primarily a pro bono activity, because I really deeply believe in what I am sharing with you. They are concerned about the futures of their businesses.

In fact, John Harbert told me that 5 years ago when he turned 68, he spent some time with his estate tax lawyer. He became aware that basically only 20 percent of the value of businesses that he was creating—and he was creating a number of different businesses—would after income and estate taxes pass to his family. At one time he had about 50,000 people employed in various businesses that he had helped start.

Now the number of employees is down to 1,000. He became aware that basically his family would keep after taxes, 20 percent. He said that did not make any sense to him. It just did not make any sense at all that he should spend sleepless nights, as he had in the past, worrying about decisions for businesses. If he lost

money, the family lost 100 percent. If he gained, family retained only 20 percent. So he basically began to stop taking risks.

To my way of thinking, that is sad. What could and should be done to help family businesses and farms is to follow the example established in Australia in 1974, as Mr. True alluded to. Australia in 1974, repealed the estate and gift taxes. They had not thought of the generation-skipping taxes. There is something more evil about leaving wealth to grandchildren than even to children to impose an extra 55 percent generation skipping. The Australian Parliament repealed the taxes because they perceived correctly that these taxes were destructive, deadly and hurt the growth and development of family businesses and farms. They wanted those businesses and farms to grow larger to provide more jobs. That is the focus they had. The sense that I get from Congress today is that you would like to create more jobs.

These transfer taxes generate little revenue. The last numbers I looked at indicated that the—all of these transfer taxes generated 1.1 percent of the revenue—.7 percent of the 1995 budget proposal. When you consider the expenses of monitoring these taxes; the amount of money spent by the Internal Revenue Service and others in court; that if you did not have these taxes, these businesses would not be forced to liquidate, and would provide jobs. If you did not have these taxes when people sold things, they would basically pay income taxes on the profits over the years the assets had been in the family—which is a great time to do it—there may be no loss of revenue in repeal.

There is no argument about value when you are selling an asset. Then you have the money to pay the tax. It may be a blow to the life insurance industry if you repeal estate taxes, but nevertheless, there are other good reasons to sell life insurance policies. So to my way of thinking, there are just a number of reasons in support of doing away with these taxes entirely so that we can have these businesses and farms continue and provide jobs.

The statistics are really chilling. Only 15 percent of businesses actually that start, make it. There are a lot of good ideas but people just run out of working capital. That is what happens to 85 percent that do not make it. You are lucky if your business is one of the 15 percent.

Only 30 percent of businesses survive through the second generation; 70 percent do not. Once again, because of taxes draining working capital. Only 13 percent make it through the third generation; 87 percent do not. Working capital to a business is like fuel to a jet airplane. When you run out of fuel, it does not make a bit of difference if you have flown 999 miles on a 1,000-mile trip to get to the airport. You just come on down and crash.

It is not like when I was in school. If you made a 99, you got an A, and I would work hard to get that. It does not work that way with working capital. Yet just at the critical time when you are shifting pilots—you started out with a little Piper Cub 50 years ago; now you have a 747—the chief pilot dies, the business is turned over to a younger pilot and the IRS starts removing the fuel from the plane. The taxes begin to suck out the jet fuel. That is when you really need the most working capital because young managers are going to make mistakes.

They do not realize their father or mother made mistakes. The parent did not come home; have dinner with the family and say let me tell you about the dumb things I did today at the office. The parent talks about successes. But the parent made his or her share of mistakes, I am sure. These new managers will make mistakes. Mistakes with a larger business cost many dollars. When they run out of working capital. The business or farm fails.

I am working with a 67-year-old client who employs 400 people—a $60 million business with seven in the family working. I have recommended to him he sell the business because it cannot cover the estate taxes. I said if you wait until death to sell it, we will get 50 cents on the dollar because people know the estate has to sell.

I have got another client who is 45 years old, the second generation owner of the business. He just bought a $180 million life insurance policy. He pays a $1.5 million a year in premiums, which is staggering. That business has quit expanding. They used to expand. But now they are taking that working capital, that million and a half to pay for life insurance. To my way of thinking, that is an absolute waste.

I have given you a chart talking about qualified retirement plans, which I find fascinating. The result of estate taxes and income taxes on qualified retirement plans is devastating. It eats up all but 23 or 17 percent. In other words, the family keeps maybe 20 percent on the average. Taxes use up 80 percent.

It is just confiscatory at the present time. The last thing I gave you was an article from the November 21 issue of "Forbes". The cover story was: "Expatriation, The Last Estate Planning Tool." People moving, like Mr. True made reference to, Ireland, Bermuda, Belize, Germany. If they die a citizen of Ireland, their estate pays a 2 or 3 percent transfer tax. If they move and become a citizen of Australia, the estate tax is zero. As a U.S. Citizen—55 percent. To my way of thinking, it is sad that people who could have that money working in our economy are leaving the country. This is a strong signal to me that we should make a change.

I am an estate tax lawyer. That is what I do. I have five others in my law firm doing estate planning and estate tax returns. My partners think that I have gone off over the edge to come here and say, put me out of business. I love to teach estate planning at the law schools. That would be over. But it is the right thing to do.

Thanks for the opportunity to share my thoughts with you.

Chairwoman MEYERS. [Presiding.] Thank you very much for being with us Mr. Apolinsky.

[Mr. Apolinsky's statement may be found in the appendix.]

TESTIMONY OF JOSEPH S. BRACEWELL, CHAIRMAN, CENTURY NATIONAL BANK, WASHINGTON, DC

Chairwoman MEYERS. Let's see, our last two are out of order here. Mr. Joseph S. Bracewell is a member of the Bank Operations Committee of the Independent Bankers Association of America. In addition, he is chairman of the Washington, DC Bank Century National Bank.

Mr. BRACEWELL. Madam Chair, members of the committee, thank you for the opportunity to meet with you today and testify

on this important subject. As you mentioned, I am Joseph S. Bracewell, chairman of Century National Bank here in Washington, and also I am vice chairman of West University Bank in Houston, Texas, so I have bank involvements in two parts of the country.

I serve on the Board of Directors of the Independent Bankers Association of America and am testifying today as a representative of the association in my capacity as a board member and member of the Bank Operations Committee.

The IBAA is the only trade association that exclusively represents the interests of the Nation's community banks. We have over 6,000 banks and savings and loans as members of our association and they are representative of all 50 States and the District of Columbia. Our interest in this subject matter that you are reviewing is both a personal one from the standpoint that many of our banks are family-owned banks, owner-operated banks, and therefore, the owners and managers of those banks have an interest, just as was expressed by earlier panelists from the standpoint of their own businesses. But also our commercial loans in the community banks across the country are predominantly centered in loans to small owner-operated businesses and family farms, and so we also represent our customers in our concern about these particular issues.

The IBAA is on record by resolution of the board and the membership of the Association as supporting measures which would help promote the continuity of family-owned businesses from one generation to another, and I can assure you that although I do represent a trade association here, that having participated for several years in the governance of the Association, that there is a tremendous amount of involvement by the individual bankers across the country in formulating these positions, discussing them and so forth. So I do speak as a banker and a representative of other bankers in addressing these issues.

Rather than reiterate many of the points that have been made before, all of which are restated in the written testimony that I have filed on behalf of IBAA, I would just like to make a few points. IBAA, to gain more detailed knowledge of some of the issues that have been discussed here, has developed a questionnaire that we have circulated to in excess of 30 other associations that represent groups of potentially similar interests, representing small and family-owned agricultural, commercial and financial businesses and many of those associations, thanks to the good work of your staff, Madam Chair, are represented here today. We hope as a result of the information we gather from those questionnaires to initiate and continue the dialog on these issues with your committee and others in the Congress to try to continue to study these broader issues related to business succession.

We are specifically supporting the provisions that have been referenced here to increase the threshold from $600,000 to $750,000. But we also, for the various policy reasons that have been articulated earlier, do support a broad review of estate and gift tax law, in an effort to try to promote the prospects for ownership succession of small businesses, which we believe the data show, and I am sure your committee is aware, that these businesses provide a sub-

stantial amount of jobs and community support that many times is lost when they are acquired by larger businesses that aren't represented in the same community and with the same amount of community roots.

So these are our positions, and again, we thank you for the opportunity to appear before you. I would be happy to answer any questions that might specifically be related to banking and the banking industry's view on this issue.

Thank you.

Chairwoman MEYERS. Thank you very much, Mr. Bracewell.

[Mr. Bracewell's statement may be found in the appendix.]

Chairwoman MEYERS. Our final witness today is Mr. Robert Spence, and I would like to call on one of our committee members to introduce Mr. Spence, Linda Smith.

Mrs. SMITH. Thank you, Madam Chair.

I am glad that you came this far. Bob is from—excuse me, Bob Spence is from Washington State. He is from Seattle. I just looked at him as a job producer. He owns three small mills, went to school in Seattle, and employs 700 people.

I see him as a person in his family, third-generation family that this could literally shut down his business because of having to pay the tax. So I am glad to see someone here that is really involved in this.

Thank you for coming, Bob.

TESTIMONY OF ROBERT SPENCE, PRESIDENT, PACIFIC LUMBER AND SHIPPING, SEATTLE, WASHINGTON

Mr. SPENCE. Thank you, Congresswoman Smith.

Madam Chair, members of the committee, I represent a third generation in my family. My grandfather started our corporation back in 1932. He passed it on to my father.

In 1970, after graduating from college and spending 4 years with the U.S. military, I came to work with my father and my brother followed me about 4 years later. I have a sister who is not active in the business, but there are three of us who are offspring, and now we have grandchildren who are starting to come into the age when they might enter the business, also.

I am also chairman of a group called The Committee to Preserve the American Family Business that was started because of my long experience with the estate tax issue. I was involved in efforts to make changes in the estate tax back in the 1981 tax bill. I haven't been involved in any efforts since that time, but because of the nature of business today and the changes that have taken place in the basic U.S. economy as far as its structure, I thought it was appropriate to revisit the issue and come here today to give testimony on it.

Our business is threefold. We have kind of a triangle as our strategy. One thing we do, we trade lumber. We buy lumber from lumber manufacturing facilities all over the United States and we export it into European and Asian economies. That was the part of my business that was started by my grandfather back in the 1930's when—through the Depression years he found a niche doing that and we have been able to maintain that as a viable function.

The second part of our business is trading in the raw material base. We trade in logs, hardwood and softwood logs. We both trade to domestic processors and we export to Asian communities that are close to the West Coast for—in the trade routes.

The third part is the manufacturing segment, which I started back in the 1970's when I came into the business. The opportunity came up for me to buy some sawmills in an area up by Mount Rainier, and we have pursued that, and it was my commitment to my role as a third-generation person trying to extend the business that had been handed down and was in the process of being transferred over to my brother, myself and my sister.

When I entered, we had 35 employees. We now have 800 employees. We have become a major factor in the four communities that have our manufacturing facilities in them. As a result of that, just through the experience, I have learned that I now have more than a responsibility to my business. I have a responsibility to those communities. The multiplier, if you will, on a business like mine—we are considered a primary manufacturer, so the multiplier for job creation in the communities that we are in is somewhere between four and seven. It depends on the economist that you talk to. But the number is like that because where we are located, there is grocery stores, gas stations, bakeries, the school system, the infrastructure that makes up the community is directly affected by what we do as a business.

Today, because of our international involvement—and we market one-third of our sales in the United States, approximately one-third in Europe and a third in Asia. We have had the advantage of being able to be in contact with competing economic entities all over the world and it has given us a mirror on what the competition is like in the international business arena.

The intensity today that we deal with in that arena, because of its high-speed nature, because of the ability for capital to flow instantaneously from one place to the next, because of the numbers of people who we have to compete with and because of the quality—the quality and the cost relationships that we deal with have made our business an extremely capital-intensive business. So today when we look at the estate tax law and we look at our business as a model of what other people in the United States have to deal with, we find similarities and we can make the case for talking to you today about restructuring the estate tax law so that we as American businesses can serve that role that we are playing now in the country and continue to allow this country to have a viable ability to maintain the purchasing power and the standard of living that we are all used to.

Small businesses have taken on a dramatically different role just in the last 5 years. Anybody who has followed the journals today knows that the large corporations have been downsizing on their employment base and the small corporations have been increasing their employment base. In fact, the current business cycle has been maintained and sustained by the actions of small businesses. Many people coming out of those large corporations have either gone to work for people like me or they have started their own new business. Their hope, of course, is that they can build an equity base

and a probably a piece of the pie called the American dream they have all heard about.

The problem I have today is I am faced with a situation with the capital intensity of my business, that I have to make a decision to either sell it or recommend to my family members that we can no longer continue the pace and the growth rate that we have been following for the last 25 years. The jeopardy is that in—and the reality is that this tax then because of that process is not really a tax on me as an heir. It is a tax on the workers and the people who I employ. We are a union. We have a union in our mills, and I have maintained good relationships with those people.

I went down and I talked to the union leader of my local union on this issue and I asked him what he thought about helping us to participate in changing the estate tax law. He looked at me and thought I was first nuts when I talked to him. He, like most people, viewed this as a tax for the rich, I mean a tax break for the rich.

The reality, though, when I explained to him that we were going to have to go into a liquidation program, which was going to affect his members who had worked in our businesses for over 30 years, then his attitude changed because he realized that that tax was not conducive to the future of their interests, it was not conducive to the future of mine.

Chairwoman MEYERS. Mr. Spence, again, I have a markup in another committee and I am going to have to leave and maybe one or two others—Mr. Torkildsen will take over.

Mr. Torkildsen, since we do have another panel, I think what I would like to do is have this panel wait and have the other panel come and speak to us before questions.

Now, would the committee rather question at this time?

Mr. MANZULLO. Let's get the new people who may not have a chance to hear the new people.

Mrs. SMITH. Let's have the next panel.

Mr. MANZULLO. Let's have the next panel.

Chairwoman MEYERS. It strikes me since people have waited for a long time, I would like to hear the next panel.

So Mr. Torkildsen, if you will bring them to the table and get started.

Mr. LAFALCE. But, Madam Chair——

Chairwoman MEYERS. Yes.

Mr. LAFALCE. I think that is a reasonable judgment. The only question I would have is will both panels remain for questioning?

Chairwoman MEYERS. Would you be able to remain for questioning?

I try to not have the committee meetings last longer than 2 hours. I think this one will probably go to 2½ hours because we do have two panels.

I must go vote and Peter, it is up to you.

Chairwoman MEYERS. Mr. Spence, have you concluded your remarks?

Mr. SPENCE. Well, in the interest of time and the next panel, maybe I could conclude and then questions could be asked.

I just would point out that I would tell you right now today in the environmental climate that—and in the climate of economics that we have, the requirement of American businesses to invest

capital to be successful is at a level that has never been before. If you look at all the social legislation that we have put in place in the last 30 years on equal rights, the ADA, the environmental control acts, the safety acts that one has to deal with as a manufacturer, the capital requirements just around meeting those requirements are intense and huge.

When we do that and when we do comply with the law and we do take the position of in good faith trying to comply with those things that were legislated by the Congress, the net effect on us as small business people is that we are inheriting a huge estate tax burden. So the penalty to us for being good operators is, in effect, a negative result.

The incentive then becomes to divest yourself. Actually for me, it means becoming retiring to the sidelines, becoming a consumer rather than a producer and giving the floor, probably in reality, to international enterprise rather than U.S. enterprise.

Mr. TORKILDSEN. [Presiding.] Thank you very much.

I thank all the witnesses for their testimony and ask for their patience in waiting for questioning after the second panel test.

[Mr. Spence's statement may be found in the appendix.]

Mr. TORKILDSEN. If members of the second panel could please come forward.

Thank you.

If the committee will again come to order.

Our second panel of witnesses is now prepared to testify.

Our first witness is Mr. Raymond Arth, a member of the National Small Business United and vice chairman of the organization's Council of Small Enterprise. He is from Avon Lake, Ohio, and he is president of Phoenix Products.

Mr. Arth.

TESTIMONY OF RAYMOND ARTH, PRESIDENT, PHOENIX PRODUCTS, AVON LAKE, OHIO

Mr. ARTH. Thank you, Mr. Chairman, and members of the committee. My need to testify today has been greatly diminished by the first panel who has said pretty much everything I wanted to say. So I will condense my comments and tell you my written testimony looks much like theirs, and I would——

Mr. TORKILDSEN. The committee thanks you for that.

Mr. ARTH. I just want to highlight a couple points and mention a couple personal factors that affect my decision to be here today.

The estate issue has been important to me for several reasons. First, like my father and my grandfather before me, I was fortunate enough to be able to start a family business, I have managed to survive and even flourish. As we speak today, my grandfather's company is now over 100 years old and still being operated by distant cousins of mine who are three and four generations removed from that founding generation.

My father's company, on the other hand, no longer exists. For a number of reasons in the early 1970's, he and his partner elected to sell the business to a large conglomerate. He was unable to operate it successfully.

I will tell you that estate planning considerations were part of the concerns that formed their decision to sell the business. That

company and the 125 jobs that it represented is no longer in existence today because of their decision to sell the business.

Another factor that makes this issue important to me is that the principal partner I had in starting Phoenix Products was my younger brother. At the point we started that business, he was already involved in what was a long and ultimately unsuccessful battle with cancer. So even though we started this company when we were only in our early 20's, we realized that estate planning and the transfer of business ownerships was an issue we had to address sooner rather than later.

We did spend a lot of time, money and effort in doing the planning, and when the time came, we were fortunately in a position to have the plans and the resources in place to address everyone's need.

You have heard the other panel describe our current system as confiscatory, and I think that is very true, and I think people are comfortable with a system like that because of a conflict between perception and reality. The perception, I believe, is that high estate taxes only affect the ne'er-do-well heir who would have spent a life of leisure living off of someone else's earnings. But the fact of the matter, and what I hope you heard in the first panel's comments, is that the affected parties are working spouses, sons and daughters of a business founder who would like to stay active and earn their living working inside a family business.

There are a couple other points that were mentioned. One is the issue of valuation. Many of my numbers pale in comparison to those previously presented, but let me tell you that the net book value of my corporation is around a million dollars. Is that the fair basis on which it should be taxed?

My banker would quickly tell you that in the event of liquidation, there is no prospect that we would realize $1 million that the income statements say. My assets, my inventories are highly specialized and only have value in the context of a going concern.

I would argue at great length that upon my death, those assets are probably worthless. At the same time, though, the Internal Revenue Service could come in, look at the results of operation in the last year or two and probably assess a value three, four, or maybe five times what the net book value represents. This creates a problem, and I am told that estate tax returns are audited as a matter of course and that conflicts over valuation can and do occur on a regular basis.

There is one other point I wanted to make that was not made by the prior panel and it really addresses an issue of fairness. Every dollar that is contained in my personal estate and every asset that our corporation owns, has been acquired with after-tax dollars. I pay income taxes on my earnings. When the corporation is profitable, it pays income taxes to the city, to the State, Federal Government. In years where the corporation is not profitable, it is still paying taxes.

We pay a franchise tax in Ohio for the right to do business, personal property and real estate taxes on the productive assets we use in the business, and a whole list of payroll taxes to fund unemployment, worker's compensation and, of course, the social security and Medicare systems.

How many bites at the apple does the Government deserve? Quite frankly, I find the notion of death annoying enough all on its own. The idea that my Government is going to come back and make one last grab at my assets when I am no longer there to defend them, is adding insult to injury, in my opinion.

One or two other quick points and I will conclude here. You heard examples earlier about the cost of insurance. What is happening in that case is that the business is paying the estate taxes continuously over time. I certainly can't point to $1.5 million dollars a year in annual premiums, but I did look it up, and in our case, with a small business, we have spent over $180,000 in insurance premiums and untold thousands of dollars in legal and accounting fees to help us keep our plans up-to-date. I suggest to this panel that is money that could be better spent to invest in jobs that would make my company stronger.

For those and other reasons that you have already heard, I feel that the increase in the unified credit amount is a good start, but you have also heard that the revenues that are raised by estate taxes are relatively insignificant in the big scheme of things, and I would urge this committee and the Congress to be bolder still.

I also support the concept of allowing business assets to be transferred inside a family with no estate tax consequence. Carry the basis over to the new heirs. If, in fact, they some day realize an actual gain over which no valuation debates can be held, then a tax should be paid.

However, I don't feel that my wife or children should have to pay ransom to try to keep our company and the bills. I am hopeful that, unlike my father, 100 years from now, one of my heirs may be able to testify about our business which is still in existence.

Thank you very much.

Chairwoman MEYERS. [Presiding.] Well, we appreciate your being here.

I am sorry I couldn't hear all of your testimony. But we appreciate you being here and speaking for yourself and for National Small Business United.

Mr. ARTH. Thank you.

[Mr. Arth's statement may be found in the appendix.]

Chairwoman MEYERS. Harry Bell, runs a diversified farm in South Carolina. In addition, he serves on the American Farm Bureau Federation's Board of Directors and is president of the South Carolina Farm Bureau Federation.

Mr. Bell.

TESTIMONY OF HARRY S. BELL, PRESIDENT, SOUTH CAROLINA FARM BUREAU FEDERATION

Mr. BELL. Thank you, Madam Chairman, and members of the committee.

I am Harry Bell, president of the South Carolina Farm Bureau Federation. I am a member of the American Farm Bureau Federation Board of Directors, and I, along with our 39-year-old son, operate a diversified farm in Saluda County, South Carolina, which is—a portion of it at least, is an extension of an operation which my grandfather started in the 1890's.

I appreciate the opportunity to comment on estate tax laws on behalf of the 4.4 million members of the American Farm Bureau Federation. Farm Bureau applauds the effort of this committee to hold hearings focusing on changes needed in estate tax law. Farmers and ranchers have a vital interest in estate taxes, because production agriculture remains a family enterprise-based industry. Without estate tax law changes, the next generation of farmers will find it more difficult to begin farming.

According to USDA's analysis of 1988 census data, roughly, 45 percent of the young farmers who had obtained land either had purchased it from a relative or had received it in an inheritance or a gift. What those numbers would be without estate taxes and capital gain taxes, we will never know.

What we do know is that multigenerational farms and ranches are a fact of life. How viable they remain will be partly determined by the estate tax load that they must carry.

Even though land prices declined in many areas of the country during the 1980's, in both real and nominal terms, they have recovered in recent years, in most areas. Take my home State of South Carolina as an example.

In 1965, the average price of farm land and buildings was $177 per acre. Now the average is close to $950 per acre. Much of the gain is due to nothing more than inflation. Due to gradual inflation and pressure from land development, the current 192,800 unified tax credit and allowance for farm use valuation are not sufficient to allow many farm-family businesses to pass from one generation to the next.

The Farm Bureau has advocated for many years that the estate tax be abolished. The NFIB's statement estimates that $1.4 billion of tax elimination annually would exempt every closely held farm, ranch and small business from the Federal tax collector's ax. If a repeal is not possible, the Farm Bureau recommends an increase in the unified tax credit, an increase in the amount of money that can be gifted each year and an expansion of actual-use valuation allowed under Section 2032A.

The Farm Bureau supports an increase in the estate tax exemption to $2 million and indexing the exemption for inflation beyond that point. Exact numbers are not available, but this level would likely exempt any farms and ranches from estate taxes and allow them to be passed from one generation to another unencumbered by Federal taxes. If the exemption isn't increased and a large portion of farm business assets must be sold to pay the tax, the economic viability of the operation can be destroyed and family members would be forced to abandon the farm.

Another estate tax issue of importance to farmers and ranchers is the $750,000 ceiling allowed under Internal Revenue Code 2032A for valuing land at its agricultural productive value. The Farm Bureau supports elimination of the $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use under this section.

This change is especially important in areas faced with urban growth. Land values for development in these areas are much higher than for agricultural use, rendering the $750,000 cap ineffective

in preserving farmland. If this cap cannot be eliminated, it should at the very least be increased and again indexed for inflation.

We also support increasing the annual gift tax exemption per diem from the current $10,000 to $20,000 per year. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family. Keeping farms and ranches in the family has never been an easy task.

I might digress just a moment to say that my parents used the gift tax to help pass on the farm to me. But the tax changes we have proposed today are a significant part of making that task just a little bit easier.

We urge the committee to work for swift implementation of these measures, and we certainly thank you for the opportunity to testify today.

Chairwoman MEYERS. Thank you for being with us, Mr. Bell.

[Mr. Bell's statement may be found in the appendix.]

Chairwoman MEYERS. Ms. Patty DeDominic is president of the National Association of Women Business Owners. She hails from Los Angeles, California. Where she founded the company DQ Personnel Services, Inc.

Ms. DeDominic, is that correct?

Ms. DEDOMINIC. Yes.

Chairwoman MEYERS. I have another vote and I will be back in just a moment.

Mr. Bartlett, would you assume the chair?

Ms. DEDOMINIC. Shall I go ahead?

Chairwoman MEYERS. Please.

TESTIMONY OF PATTY DeDOMINIC, PRESIDENT, PDQ PERSONNEL SERVICES, INC., LOS ANGELES, CALIFORNIA

Ms. DEDOMINIC. Chairperson Myers, Small Business Committee members, thank you for the opportunity to present testimony today on the issue of estate taxes.

As you know, my name is Patty DeDominic. I am the president and sole stockholder of PDQ Personnel Services. It is a company I founded 16 years ago with my last $2,000 in savings.

PDQ is based in Los Angeles, and today PDQ, with an annual payroll of over $10 million is one of the largest LA-based women-owned businesses. I also happen to be a partner in two other small firms, one which my husband runs and one which a young woman runs who is a former employee and now she is managing partner.

While I want to narrowly focus my remarks today, I want to assure the committee that my perspective is not narrow. It is broad from a number of different experiences. I serve on local and national committees addressing the issue of employment, development, business and Government.

I recently completed my second term as vice chair of the Los Angeles City Private Industry Council and I was a pilot mentor in the U.S. Small Business Administration's Women's Network Entrepreneurial Training Program. I mentioned earlier that I wanted to assure you that my perspective is broad.

I speak to you not only as a representative of NAWBO, the National Association of Women Business Owners, but as a mother of three, a grandmother of four, a taxpayer, a vendor to big and small

business, as well as nonprofits and Governments, a person whose company places over 2,000 people in jobs each year, and as a community volunteer.

I serve on the board of the Greater Los Angeles Chamber of Commerce, the California Youth Employment Opportunity Foundation, the American Red Cross and several other organizations. NAWBO is headquartered here in Washington, DC, and we are the voice and vision for America's women business owners.

We are the only national dues-paying membership organization representing the full circle of women entrepreneurs, owners of big and small companies. NAWBO has 52 chapters around the country and a growing number of affiliate organizations and at-large members.

We were founded 20 years ago and we are also a member of FCEM, which is Women Business Owners International, a group that represents 33 countries.

I just want to depart for a moment on my prepared testimony and tell you how much I appreciate you being here and how much the chapter presidents from our 52 chapters appreciate you watching out for small business. I know many of them would have liked to have been here to support this, but as you know, it is expensive to travel across the country. But they extend their thanks to you and I, too, extend my thanks to you for paying attention to these issues.

My comments will be focused on the estate tax provisions, as we have been discussing earlier today. We would definitely like to speak in favor of raising the nontaxable estate taxes from the current $600,000 exemption to $750,000, and to small business valuations. NAWBO supports increasing the amount of both the estate and gift exemptions to a rate more equitable with inflation.

First, we realize that such an increase would have a tax impact, although the benefit would be a relatively small reduction in taxes for estates over $600,000. But we would like to point out that any tax relief for small business is a welcome step in reforming current tax legislation that adversely affects small business. As you probably know, just a few thousand dollars in the hands of an entrepreneur with drive and vision can often be stretched and is stretched every day over 10 times.

Second, a $750,000 estate is now becoming common even without a business. Take a person has a residence, life insurance, profit-sharing plan or rollover IRA, some savings and they may already come fairly close to that equivalent figure.

Third, the real problem is that the exemption equivalent figure at $750,000, the tax rate starts at 39 percent and increases to a rate greater than 55 percent by the time you reach $3 million. The tax on that additional $2.25 million is over $1 million, and increasing rapidly.

A better solution to the problem might be to make the $600,000 a lifetime exemption for gift and estate tax purposes to be indexed for inflation. This would help the small businesses and individuals owning their own home, having life insurance, profit-sharing plan or a rollover IRA and some savings to handle the tax burden, on value of property in excess of $600,000 starting at a rate of 18 percent, and then going up, if we must, to 55 percent at $3.6 million.

Fourth, there is a need to increase the annual gift tax exclusion from the present $10,000 to at least $15,000 and thereafter to index. It is important to keep in mind that raising the ceiling could make the difference between whether a family or heirs inheriting the business are able to continue the business. We are not talking about $20 million or billion-dollar businesses here, but rather a growth-oriented small business, where the value of the home and the business for many small business owners is at the $1 million mark or greater.

Real estate alone in today's market is pushing even many of the smallest businesses into the $600,000 category. This amount has not been indexed to inflation, as you know, and has not been raised since 1987. The $750,000 is reasonable since there has been no change for the past 7 years, and if you inflated the index by 4 percent over 7 years, you would be looking at an increase to $790,000. If you inflate in line with inflation, the $750,000 seems to make good sense.

Small business valuation is another major issue for small businesses. When the owner and the primary decisionmaker dies, as my colleagues have said earlier, the business can go downhill rapidly. If the prior revenues and net assets are tied to the deceased owner's success and therefore overvalued, we can be in big trouble.

Normally, because family members inheriting the business may not have the financing to get the company back on track after the owner's death and it is already difficult enough for us to get financing in the first place as small business owners, so imagine what an inexperienced family member might deal with. In order to get financing to run the business or to keep it going and pay estate taxes, the best argument is to value the business lower. If the business goes under due to high—to too high a valuation and to taxes, everyone loses.

Today, America faces the most extensive far-reaching fundamental challenges since the Industrial Revolution: The shift to a knowledge-based economy, the growing demand for training in the workplace and the need for economic growth.

As all these challenges and changes occur, women are having a greater impact on the national marketplace. Over the last decade, women in the United States have gone into entrepreneurship at a rate actually faster than men going into entrepreneurship. We now own over 30 percent of American businesses. Many of you probably know that we employ over 11 million people here in the United States and that number continues to grow. Some of these businesses have been inherited and some are family businesses.

Establishing fair small business valuations and a more equitable estate tax makes good business sense.

On behalf of NAWBO, I would like to again thank you for your time today and applaud your efforts to hear the voices of small business. We look forward to continuing our partnership with you and with America.

Mr. BARTLETT. [Presiding.] Thank you very much for your testimony.

[Ms. DeDominic's statement may be found in the appendix.]

Mr. BARTLETT. Our next witness is Mr. Mark DeVorsatz?

Mr. VORSATZ. It is Vorsatz. It is misspelled.

Mr. BARTLETT. Thank you.

Who represents the American Institute of Certified Public Accountants where he serves as Chair of the Estate and Gift Tax Committee.

Thank you very much.

TESTIMONY OF MARK L. VORSATZ, CHAIRMAN-ESTATE AND GIFT TAX COMMITTEE, AICPA, SAN FRANCISCO, CALIFORNIA

Mr. VORSATZ. Thank you very much, Mr. Chairman.

I am here on behalf of the AICPA, which is a professional society of accountants which has over 320,000 members, many of whom work with small businesses on these types of issues.

To help you understand my frame of reference, I am a tax partner with the international accounting firm of Arthur Andersen. I am based in San Francisco, and I will share with you that I had the opportunity to enjoy the Super Bowl in Miami on Sunday.

My primary area of focus is what I would call family business consulting. So many of the people, much like Mr. Apolinsky who testified earlier, many of the people who are here today are the types of people who I provide service to.

In the normal course of an engagement where I work with a family business owner, one of the initial questions that I pose to that individual is, if you had to add debt to your company in the amount, roughly, equal to 55 percent of the net worth of your business, would it change the way that you would operate your business?

Now, most of the business owners that I deal with view that as being somewhat of a silly question because, of course, it would change the nature in which they operate their business. In fact, the normal reaction among the business owners is usually that they could not continue the business if they had to add that kind of liability to their company.

Imagine even with many of the Fortune 500 companies which are public, what the ability of the company would be to expand or survive if they had to add that kind of liability to their business. I think the key issue that has come out in the testimony earlier is that estate taxes are a controlling factor in the way the companies are managed, it is an economic issue that interferes with the ability for the company to function.

Mr. Apolinsky previously referred to I think what I would call the impact estate taxes have on how a company is managed, the business decisionmaking process. Mr. Bracewell highlighted a point which I find to be more and more common, and that is the ability of companies to obtain financing where the commercial lenders recognize that the Government is going to have a priority lien against the assets of the company which is equal to 55 percent of the net value of the business. As you can appreciate, that certainly changes the loan-to-value ratios for the operating entity.

Mr. Spence and Mr. True previously talked about the impact it has on employment. This is not just an isolated issue that impacts the family. That estate tax burden impacts the people who work for the company, as well.

Our organization has been involved for the last couple of years in trying to define a proposal in this area of family business tax

issues and our proposal is identified as a relief provision, and we have submitted written comments on some of the specific provisions that we are suggesting.

A couple of key points that I would want to underscore. First of all, this area of tax law is so complex that it has a chilling effect on the ability of people to plan. Many business owners are overwhelmed by the complexity of tax laws in this area.

As this committee, I am sure, appreciates with the repeal of Section 2036C and replacement of that with chapter 14 many professionals are having difficulty keeping up with the importance or impact of these provisions. So it is causing inaction in this area.

A second area that I would want to point out is the importance of having certainty and predictability with respect to the tax law. Our proposal addresses equally important is having certainty with the understanding and the implications of this tax law as well as the economic effect.

Then the third thing is I think, as most of the people here who have testified to already today, is the economic cost associated with the estate tax law on family-owned businesses. I wanted to bifurcate that subject matter into two areas: One being the issue of predictability and certainty on—of the estate tax law. The second being the economic issues.

We have three major points that I want to underscore on the issue of predictability and certainty: The first is to establish a safe harbor interest rate under chapter 14. The chapter 14 rules under section 2701 do not have any guidance, unlike most of the tax provisions, and there is tremendous uncertainty as to what is a fair market value interest rate.

An alternative would simply be to reference the applicable Federal rate, which is something that is used throughout the code in many other areas and this would at least give business owners the opportunity to effect planning alternatives.

The second is under section 2703, the comparability provision for buy-sell agreement. What we have seen with the change with the introduction of chapter 14 is very few business owners are proceeding with buy-sell agreements because of a lack of understanding of what constitutes comparability. As a practical matter, I find that impossible to administer.

Having a comparability for a private business is an oxymoron. How do you obtain information as to private companies? This is not like a public company where comparability of information is readily accessible. So our proposal suggests that the issue of comparability, that provision of the section be eliminated.

The third, which I think is an area which would really emphasize or reiterate the opportunity for predictability, and I view this as a win/win for the Government and the taxpayer, is an advanced valuation provision, similar to what has currently been implemented under the international pricing rules. That is that a taxpayer who is proposing a transaction could file a request for a ruling with the Internal Revenue Service requesting that the valuation be addressed at that point in time before the individual proceeds with the transaction.

Similar to the advance-pricing agreements, there could be a user fee. What this does for the taxpayer is provide certainty as to the result if the transaction is approved by the Government.

So those are the three issues that we want to highlight as far as predictability and certainty. The other issues—the other economic issues, three that I would also like to address, two of which have been talked about already. One dealing with the interest rate under Section 6166.

A number of proposals have suggested exempting small businesses from estate taxes. At a minimum, we would suggest that the interest rate be limited to 4 percent on the entire estate tax liability, providing a fair market value interest rate only gives the business owner instant financing. That is not a relief from the estate tax cost.

Second, is the increase in unified credit, that is included in our proposal and it is very similar to that contained in the Contract With America.

Third, focusing again on this issue of complexities, we are proposing an exemption from the chapter 14 rules for small businesses. Many small businesses do not have the luxury of affording high-priced advisers who understand and comprehend and appreciate the complexity of these provisions, so we are suggesting that a form of relief would be simply to exempt small businesses from the application of chapter 14.

Thank you very much for the time, and I appreciate the opportunity to be here.

Mr. BARTLETT. Thank you very much.

[Mr. Vorsatz' statement may be found in the appendix.]

Mr. BARTLETT. It is always nice when one of our witnesses has a special relationship to one of the members of the panel, so it is my pleasure now the ask Representative Linda Smith, if she will introduce our next witness.

Mrs. SMITH. Well, yes, I will.

Chan Noerenberg is not only a tree farmer—we do grow trees in the Northwest as a crop—but he is a good friend and he has a sixth-generation, 200-acre tree farm in a little place called Castle Rock, Washington. Important place at home, but very small. This is Chan. We call him president in our area because he is the president of the Washington Farm Force, actually vice president this year.

Thank you, Chan.

Mr. BARTLETT. Yes, sir.

TESTIMONY OF CHANDLER NOERENBERG, VICE PRESIDENT, WASHINGTON FARM FORESTRY ASSOCIATION, CASTLE ROCK, WASHINGTON

Mr. NOERENBERG. Mr. Chairman, my name is Chan Noerenberg. I am the vice president of the Washington Farm Forestry Association. Our association represents nonindustrial family tree farmers throughout the State of Washington. I own, manage and work my own timberland.

Thank you for giving me the opportunity to testify today before the committee concerning legislation which is vitally important to the 7 million nonindustrial private landowners throughout the

United States. The legislation addresses one of the most pressing issues that affects family tree growers, the Federal estate and gift tax laws. Something has to be done about laws that force inheritors and participants in a family farm or business to sell that enterprise in order to pay estate taxes.

In my oral remarks today I want to make three points: First, I want to be sure the committee has a feel for the uniqueness of family tree farms. Second, I want to outline the legislation very briefly that we endorse to correct this inequity. In my written submittal prepared by SITE, gives the details.

I want to relate this malignant public policy to another issue that this Congress will address, the Endangered Species Act and illustrate a blatant contradiction in how we manage our affairs. Let me give you one example of why I find it necessary to define tree farmers for the committee. Throughout 1994, we met with the U.S. Fish and Wildlife Service. The subject was defining the 4D rule of the Endangered Species Act which is saving the spotted owl on private land.

The service is considering grand sweeps of land to be locked up as future disbursal habitat for owls. The discussions revealed to them for the first time the economic necessities that human beings get from the land, food on the table, paying mortgage payments, tuition, and so forth. They seemed surprised at the resistance to a land lockup. The second surprise to them by their admission was that the ongoing IRS collections of Federal estates taxes was eradicating vast stands of trees, potential owl country.

Now, that was a problem for the service. They are good people and our talks have been productive as they have progressed. There are other instances where we the owners of 40 percent of Washington's private forest lands have found ourselves not only outside the beltway, but totally out of the loop. We are thinking of adopting Rodney Dangerfield as our mascot.

I know your deliberations will address many kinds of small businesses. Tree farming is somewhat different. These are just some of the ways. Our crop takes 40 to 60 or more years of nurturing before we harvest. Several generations of one family are likely involved in putting effort where there never can be financial reward but gaining rewards from the work and dedication of a departed family member.

My 11-year-old grandson Colin and I have planted many seedlings together. I am planting this season 7,000 seedlings, trees for harvest in the year 2050 when Colin will be 67. He is the sixth generation of my family on this land.

This slow and satisfying process creates an especially strong family relationship with the land and their heritage. There are 30,000 small owners in our State, and for many, these slow-paced harvesting income is how food is put on the table and mortgages are paid. Standing trees is the nest egg for retirement. Timber and reserve may pay for unexpected health costs or for expected education costs.

The entire fabric of the lives of frequently three living generations of a family can be woven into the timberland. Careful gentle forest management, infrequent small harvests and a love of the critters characterize many family farms, farms that are now at

great future risk due to estate taxes. Land and timber values are liquid and nonincome producing except at harvest.

Their values have risen dramatically from the effective inflation. In the 1930's, timberland out our way sold for 50 cents an acre, and trees my grandfather sold earned him $5 a $1,000. Today, land is going for over $1,000 an acre and the next species harvested may fetch $600,000 or $800,000. The estate of a tree farmer who died without fancy estate planning and had 60 to 200 acres, which is a modest plot, could be $3 million and create a tax bill of $1 million due and payable in 9 months. The only resource cash available are the trees.

It is now commonplace in our area for frantic, panic harvest to take place to pay predatory, confiscatory Federal and State taxes. Within eyesight of my property, I can see needless clear-cuts of 160 acres and 400 acres solely forced by estate taxes.

Estate tax reform is of urgent concern to WFFA and the Four-State Wood Owners Council. We are heartened by your committee's interest in this matter.

As I said, I am submitting written testimony today that our group is endorsing, and I find it remarkably similar to what the Farm Bureau proposes. I am told it is among the lowest cost proposals which you will hear.

This recognizes the importance of children and other heirs who work in a family enterprise. They are devastated to find the beneficiary of the life work of a business is the Internal Revenue Service. Their desire to continue the venture is frequently snuffed out.

Very briefly, the heart of our proposed legislation, the National Family Enterprise Act, is to increase the current unified credit of $192,800 to $314, and this would be an increase of $600,000 to $1 million in the amount of property that may pass free of Federal, State and estate taxes. The current annual exclusion of $10,000 would be increased to $20,000, and the special-use valuation would be increased to $1 million from $750,000.

The value of the gross estate shall be reduced by 5 percent for each taxable year in which a qualified family member participates in the active management of the family farm or business following the decedent's death. The estate would be credited for the maximum deduction at the time of the death. The family member must continue to be in the active management for 10 years following, otherwise a recapture provision would apply.

In closing, return with me to the desecration, the leveling of entire family tree farms to pay the death tax. It is stupid land management for sure, and mindless, meat-ax wildlife habitat treatment.

The Endangered Species Act, especially for the owl, the marlin, mullet and the salmon seems to suggest more broad-based land management to accommodate many species in many locations, while still producing commodities. If this is the answer as wished by the Fish and Wildlife Service, then somehow we must call off the IRS death tax process which is leveling our forest habitat at an alarming rate.

Thank you for the opportunity to testify.

[Mr. Noerenberg's statement may be found in the appendix.]

Mr. BARTLETT. Thank you very much, and thank all of our witnesses.

For those of you who have written testimony, without objection, that will be included in the record. We would encourage you to do that.

[The information may be found in the appendix.]

Mr. BARTLETT. We have the first panel who is also here. We would encourage you to sit so that you are conspicuous so that you can be asked questions by the Members here.

My background in another life was at least partly in the business world. I was an entrepreneur, started a family business, ran it for 10 years. Every Wednesday morning my wife and I met a payroll. So I know where you are. There is an old axiom in the physical world that energy or power to be effective must be concentrated.

There is enormous potential energy in the ties, but we have been essentially unsuccessful in harnessing the energy that ties, primarily because that power is not concentrated.

I think that that same axiom is true also in the economic world. The taxes that you have been talking about are really an attempt to redistribute wealth. I think that in the short run, as well as the long run, that this is really totally counterproductive to what America wants and that is more jobs and a better economy.

When you look at the fact that almost all of the jobs, 98 percent of all jobs in the recent past were produce by businesses with zero to four employees, you see how very important small business is and you see how important these taxes are to small business.

The 10 witnesses have demonstrated a real attempt on the part of business to survive, in spite of Government. Our last witness talked about the predatory, confiscatory taxes, and those are two very good words to describe them. I forget who the author was who described these taxes as legal plunder, and that perhaps is another fair way of characterizing them.

There are said to be two big lies in this country; the first is that the check is in the mail and the second is that I am from the Government and I am here to help you.

We are here to help you. That is our intent in this committee. We are indeed here to help you.

I personally thank you very much for your testimonies. My apologies again for what happens here. I need to be on the floor. I had to be absent for a little bit to be at the beginning of another committee. I need to be on the floor for the unfunded Federal mandates bill.

We want to make sure that good science is applied whenever auto emissions are imposed, auto emissions testing are imposed upon our people. Part of the district that I have the great privilege of serving, are Appalachia, and we are now having auto emissions tests imposed on us.

Thank you very much. That is not one of our high priorities in Appalachia. With your permission now, I will turn the chauffeur over to Mrs. Smith.

Mr. Torkildsen has again and ask her if she will be the next witness and take over the chair and then continue the meeting.

Thank you very, very much for your testimony, and I am sorry that I have to leave.

Mrs. SMITH. [Presiding.] Following the tradition of this committee, we will have the Members as they came in this morning ask questions and make a statement.

Mr. Poshard would be first.

Mr. POSHARD. Thank you, Madam Chairlady.

I appreciate the opportunity to listen to all of you testify this morning on this very important subject.

I guess I would ask my first question to Mr. McNutt, since I think he was the first one to raise the issue. But the reasoning behind our raising the exemption, and/or indexing it to inflation or getting rid of it altogether, is too, I think, your explanation of that was to maintain the continuity of the family business. That is what all of you basically spoke to.

Mr. MCNUTT. That is part of it.

Mr. POSHARD. Yes, sir. What safeguards then would we—would you be willing to accept if we did any or all of those things with respect to that purpose? Should we require so that we are sure that we are designating this, the family-owned businesses or farms? Should we require the heir to have had some practice in running the business before?

Should we require them to continue running the business for such a period of time? What safeguards are in there to say, well, OK, here is a son that hasn't been around the business his whole life. He is going to inherit the whole thing now, and 3 weeks down the road after you are dead, he is going to sell it. What prevents that? What do we need to ensure that we prevent that from happening if we are going to do this for you?

Mr. MCNUTT. I don't know. You guys have to find a way to figure it out.

Mr. POSHARD. I wish we did.

Mr. MCNUTT. Don't make it so complicated that we can't live with it and understand it. I am one that feels that Government is to serve, and what safeguards do I have from Government? You want to confiscate 55 percent of my wealth. I guess I have a 45 percent safeguard.

Mrs. SMITH. Could you speak into the microphone. I know it is awkward.

Mr. MCNUTT. It looks like the worm is going to hopefully turn in favor of people who work and earn and feel philosophically like this group that has been here this morning. It is not fair to say we have had no representation. We have had no victories in a long time, long time.

Mr. POSHARD. Well, I don't want to get into debating that issue. Because I, as a Democrat, I have some real strong opinions about that.

Mr. MCNUTT. Quite honestly, I hadn't—that would take thought, what kind of safeguards. I just don't know. I am sorry.

Mr. POSHARD. Well, that is OK.

Does anyone else want to address that?

Mr. VORSATZ. Yes. I mean, I think there are provisions similar in section 2032A and 6166 if there is a disposition of the business and—as you may recall, Senator Breaux did propose a bill about a year or two ago.

Mr. POSHARD. Exactly.

Mr. VORSATZ. That had some provisions that if the business is sold, there would be an acceleration of the estate tax liability. I think Mr. Noerenberg referred to it in his testimony of having some gradual reduction in the tax tied to the business continuity. So I do think that is a very workable thing that could be integrated as part of the process.

Mr. APOLINSKY. Mr. Poshard.

Mr. POSHARD. Yes.

Mr. APOLINSKY. Harold Apolinsky.

I would like to respectfully dissent from this concept. We have too much complexity in the tax law as it is now. I gain from that as a practicing tax lawyer. I enjoy explaining it to clients and to students. But 2932A, which got into law in 1976 with the grand purpose of saving family farms, was drafted in such a complex way. It covers 11 pages of the Internal Revenue Code. Four years ago, I was up here testifying in support of repeal 2036(C) and against the substitute of the very complex chapter 14 that did not help family businesses one iota. There were at that time 80 court cases that had been decided on 2032A, and probably another 80 were in the hopper. So 2032A has been a wonderful lawyer and accountant relief act. We are grateful, but clients estates are not.

But my thought would be, you do not need to worry about taking a chance. If the business leaves the family, then there would be no increase in basis since there is no transfer tax to be imposed.

A capital gains tax would be due, whatever that rate was. That rate may seem small—28 percent, and maybe it will drop to 20 percent, compared to 55 percent estate tax. But I remember not too many years ago when capital gains were at 49 percent. To my way of thinking, the safeguard is when the asset turns into cash, people pony up. That is when values have been determined and that is when the money is there. No more litigation involving the question of "fair market value."

Mr. POSHARD. OK, Ms. DeDominic?

Ms. DEDOMINIC. I would like to say in my business in Los Angeles, I spend several hundred thousand dollars a year on lawyers, accountants and insurances protecting my business and my employees from the safeguards that were put in supposedly to protect. So I just want the assure you the gist of my comments were not to preserve family-owned businesses, although I am definitely for that.

I am talking about putting a few thousand dollars back into entrepreneurs' pockets so we can take that $2,000 or $5,000 and create two more jobs or grow our businesses and assist our employees in training programs and other types of things. So I just ask you to please be careful about giving us safeguards because they really sometimes have incredibly negative unintended consequences on businesses and employees.

Mr. POSHARD. Some of the business organizations themselves have recommended that along the way, and I was just wondered what you folks would be willing to settle with.

Let me go on, if I may, to a couple of other things. Again, I asked this question the other day about the capital gains tax exemption. Given the choice, let's say, there are some real questions raised about revenue neutrality here with respect to this, and we all know

the budget crisis we are in, and so on. Given the choice, one or the other, would it be more important for us to raise the exemption or to index it to inflation?

Mrs. SMITH. Before you answer, keep it very quick. He is over his 5 minutes.

Mr. POSHARD. Madam Chairman, I assumed since we are entertaining two panels we could go a little longer.

Mrs. SMITH. Sir, you might end up being past noon yourself. Let's see if you can keep your answers quick.

Mr. POSHARD. Then I will end with that question, if as many people could answer it as possible.

Is one more important than the other?

Mr. BELL. We think they are both important.

Mr. MCNUTT. If I had to select one, I would prefer the index for inflation because you raise the ceiling, you still have inflation in 2, 3, or 8 years down the road. With no law change, you are kind of back where you started.

Mr. ARTH. Had the index been adjusted for inflation in 1987, I think the current level would be close to $780,000. Inflation actually exceeds the 25 percent proposed increase.

Mrs. SMITH. Mr. Spence.

Mr. SPENCE. That is a very difficult question to answer, because if you are a capital-intensive business, the indexing helps the—both issues help. The problem, though, is that we have to pay that tax, if we are above—if our valuations are above the current law's exemptions and credits, then what we do is we have to sell the assets of our business to pay that tax. What we are doing is selling the jobs of the people, because those assets are important to running our businesses.

So our concept, if we were to complicate this thing, we prefer it simple, too, for all the reasons that these gentlemen and ladies have laid out today. But we prefer a targeted approach, because what we want to do is exempt operating businesses so that they continue. We think there is a moral argument to allow our businesses to continue.

We have proposed at some searching of our conscience, because it does complicate the law that an heir be required to stay in operating—or heirs be required to stay in operating those businesses, and if they were to stay for a period of time, then say, 10 years, they would be exempt from the estate tax. If they sold in the first year, maybe they pay 90 percent. Or 80 percent the next year, and rotate it down.

We think there is problems with that also. But if we had to choose, that would be our recommendation.

We also took that approach because we feel there is justification for exempting people from inheritance, but there is less justification if they are inheriting cash or liquid assets. But in the terms of operating businesses, the moral obligation and—of you folks, as well as us to the communities that we are involved with, dictate that this issue be addressed and that if we have to make concessions, we make those concessions in a pragmatic way. If that is a requirement of budget revenue needs, then so be it.

But what our objective is really, is to perpetuate the emergencies testimony to operate in an effective, competitive way internation-

ally. We will tell you, I think anybody will tell you, and I can tell you from responses of peers that I have talked to all over this country, from every State in this Union, that is exactly how they feel.

Thank you.

Mrs. SMITH. Thank you.

Mr. Longley.

Mr. LONGLEY. Thank you.

I just want to preface my remarks by saying that I have some understanding of what you have been talking about. My family lost a small business. I won't say completely because of the need to pay estate taxes, but it was very definitely a part of it. As a result of that, there were approximately 10 or 20 jobs in my State that left the State, went to another State, because the headquarters was moved 2 years later based on the financial considerations of the new owner. That may not seem to some to be a big deal, but it certainly has made a very big difference to my family and to the 10 or 20 people whose jobs were lost.

I want to ask a couple questions, and I think we have got a tremendous panel here. One of the concerns I have got is that you are all individually offering a tremendous amount of information, and I think there might be a need to kind of tie it together into a nice little package, to the extent that that is possible. So I have a couple quick questions.

One, I noted, Mr. Spence.

Mr. SPENCE. Yes.

Mr. LONGLEY. You indicated that a state-of-the-art sawmill today costs about $50 million.

Mr. SPENCE. That is correct.

Mr. LONGLEY. And would employ about how many people?

Mr. SPENCE. In our sawmills, we run our sawmills two shifts, so there is approximately about 125 people directly employed in the sawmills. Then we have a trucking fleet that is associated with the transportation requirements, which adds another—we have 100 people with our three sawmills, we have 100 people employed in our trucking fleet. So——

Mr. LONGLEY. So figure you have got 125 jobs, minimum, maybe close to or in excess of 200 jobs that may tie into one particular sawmill?

Mr. SPENCE. If you include the transportation component and some of the logging components, yes.

Mr. LONGLEY. That would be exclusive of potentially the woods workers who are supplying the raw product for the mill?

Mr. SPENCE. It would be, yes.

Mr. LONGLEY. I noted, Mr. Bracewell, you made a comment in your testimony that on the total value of a sawmill that—where is Mr. Bracewell?

Mrs. SMITH. I think Mr. Bracewell had to leave. He is not here.

Mr. LONGLEY. He made a comment. I will maybe ask Mr. Spence.

About 25 percent of the total value of the sawmill was attributable to improvements made for occupational, safety and health and environmental expenses; is that on a par with you?

Mr. SPENCE. Yes. Our capital budget last year for the three mills was right around $12 million, and we spent——

Mr. LONGLEY. That was a capital, annual capital budget?

Mr. SPENCE. Annual capital budget, yes. That is what it is taking us every year to keep our equipment in tune with the times.

Mr. LONGLEY. So if I looked at the $50-million you used for the state-of-the-art sawmill, what percentage of that, in your experience, would be attributable to improvements made to comply with governmental health, safety, occupational regulations?

Mr. SPENCE. Well, to answer that, we figure, roughly—we calculate the replacement value of our asset base and then we figure about 10 percent is what we have to come up with to maintain a base level in efficiency. Last year, 10 percent of that was the amount of money that we spent on those kind of issues.

Mr. LONGLEY. Now, I would like to shift to—we are fortunate, I suppose, to have an attorney and an accountant here.

Mr. Apolinsky, again, I have been a student, as I mentioned, I am an attorney. I have studied the Estate Tax Code. I have worked with businesses in business and estate tax planning, and I wouldn't presume to substitute my judgment for yours.

Let's assume Mr. Spence has come in to see you with a hypothetical sawmill worth about $50 million. Again, I understand based on his testimony that maybe $5 or $10 million of that is attributable to improvements of one sort or other which are to comply with policies of our Government, which are good policies. He is in his 50's or 40's. What advice would you give Mr. Spence? What are his options as an owner of a business?

Mr. APOLINSKY. It is probably the greatest challenge an estate family attorney faces is how to keep a family business or family farm in the family. The first thing you think about is you ought to start making gifts to your children at that time. Sometimes people are not ready to do that. They have not decided who is going to run the business or farm—the inside people—and who are going to be the outside owners. It is dangerous to sort of mix them. But you tell them about that. Even with gifts, there would be no way to pass the business intact to the family. Too much working capital would be lost in taxes. Paying over time—at current interest in the main—or using working capital for large insurance premiums would not solve the problem.

You tell them about—first of all, Mr. Longley, you quantified, as you probably did in your practice, the amount of the tax and you look to see if there is any cash or liquid funds.

Mr. LONGLEY. What would the tax be on a business of approximately $50 million in value?

Mr. APOLINSKY. I would say, roughly, a little more than $27 million.

Mr. LONGLEY. So that $27 million tax is on top of existing taxes that are already paid for income that the business owner might earn.

Mr. APOLINSKY. That is exactly right. Exactly.

Mr. LONGLEY. Roughly, if you accumulated local, State and Federal taxes as a percentage of income in business, do you have any rough figure that you might provide us with?

Mr. APOLINSKY. I with say, roughly, in the neighborhood of 40 percent for income taxes alone.

Mr. LONGLEY. That would be a conservative estimate?

Mr. APOLINSKY. That would be conservative.

Mr. LONGLEY. So you have a business generating income, paying income taxes at the 35 to 40 percent rate. We have already discussed the 150 employees, each of whom is probably already paying income taxes and social security taxes and FICA taxes, and you are supporting a community. Now the business owner is now confronted with paying $27 million. What happens to him if he doesn't make appropriate plans?

Mr. APOLINSKY. The business will have to be liquidated or the business will have to be sold. Uncle Sam wants a check for $27 million 9 months after death.

Mr. LONGLEY. So in your experience, when a business owner—let's assume—I am assuming that selling the business is an option. To what extent does a small family-held business end up being purchased by another family or an individual?

Mr. APOLINSKY. I think that is rare. I think it takes a large business to come in and buy a small business, if you are fortunate enough to have someone that you can possibly sell to. I think that is what causes the loss to the community, because now it may be owned by a European company or it may be owned by an Asian company, and that may be the market that you have had to sell your business.

Mr. LONGLEY. In your experience, when that occurs, what are the implications to that business?

Mr. APOLINSKY. It is a very different kind of business. Because the person that has had to borrow quite a bit of money to buy the business, they have to have a return. They have paid $50 million for a business. They have to have a return on that $50 million. So they have to operate it in a different way.

They have to reduce the employment. They have to look for a number of ways to try to generate the return on their investment. We have seen it in so many different kinds of businesses when they are—when they are purchased by someone else, not only do you lose the community commitment, but you typically don't have a growth mode. You have a more conservative mode as you are trying to provide a return on this significant amount of money that the buyer had to put out. So, to me, it is a negative for both the company and the community.

Mrs. SMITH. Well, thank you. I think we let that go long beyond 5 minutes.

Mr. LONGLEY. Thank you. I appreciate your indulgence.

Mrs. SMITH. I guess I am going to ask a question of that, because I think what we are leading to is the issue of the estate tax itself and whether we should have it or not.

For your information, we had an initiative in Washington, we repealed our estate tax. I think it was repealed by nearly three to one. The people innately know that taking away the fruits of a person's lifetime labor is wrong. People pay taxes and we are a fairly high-tax State.

They know that, but they repealed that like lightning. The governor tried to put it on this year again, became so hot so fast, he took it off the table, his polls plummeted to the floor.

I think with that, I want to ask you a more—I do agree that we should eliminate the estate tax. I believe that the people would eliminate it nationally. As innately, just plain unfair.

As I look at that, and my background was tax planning and involvement in people's finances, I know where there is a will, there is a way.

So maybe this question, Mr. McNutt, you recommended we get rid of it somehow. My question is, how do we make sure that we don't have people figuring out a way to transfer assets to get around—I can just see some real interesting possibilities, creative possibilities of shifting assets. Can you see anything we would need to do? I can see some possible abuses, or maybe I just have a creative mind.

Mr. APOLINSKY. Could I respond to that?

Mrs. SMITH. Yes. I don't like to overmanage or oversupervise, but I think I could probably use the help.

Mr. APOLINSKY. I don't want to take Mr. McNutt's—I would defer to our legal and tax counsel down the way.

Mrs. SMITH. I guess when we are thinking about tax elimination, I guess if I can think of ways to use an elimination, maybe you could, too, and you could help us with those kind of arguments.

Mr. APOLINSKY. I agree with you. I think that is the disadvantage of trying to develop a carve-out for certain kinds of businesses that can be inherited or certain limitations on that, because you have a creative mind. We are blessed in this country with people who have creative minds. It is a wonderful survival urge.

My thought is, if we could take the bold step of just repealing the laws in their entirety, like they did in Australia, then that completely takes away the gamesmanship and it focuses on entrepreneurial activity which seems to be the healthy thing. In fact, it seems to be what we have to do if we are going to kick-start our opportunity to compete worldwide.

Mrs. SMITH. Any other comments on that?

Mr. TRUE. Madam Chair, if I may, Diemer True from Wyoming again.

We have just gone through that circumstance, as I mentioned in my oral presentation. The three brothers of us, in essence, purchased the assets of the business from my father's estate and from my mother. The cash has ended up in mother's estate. That is our working capital. So if you were to artificially determine that the cash that is in mother's estate is for some reason to be taxed, while the business assets which are owned by the three brothers would not be taxed, that is still our working capital. That is the basis upon which we are able to continue the businesses that we have in Central Wyoming.

Mrs. SMITH. So I think, if I were to summarize, that you would like to just see it eliminated, too.

Mr. TRUE. If we could, that is true.

Mrs. SMITH. I didn't mean to minimize what you just said. But I think that seems to be the most reasonable way. Of course, it is costly, too.

Thank you.

Mr. MANZULLO. Madam Chairwoman?

Mrs. SMITH. Mr. Manzullo?

Mr. MANZULLO. It is easy, like Smith——.

Mrs. SMITH. Excuse me. Yes.

Mr. MANZULLO. I practiced law in the country for 22 years, represented a lot of farmers, and I don't know of any tax issues that are raised to the level of a moral issue, except for the estate tax when it comes to farmers.

When I graduated from law school, I could set up my own practice, still could do it today for $20,000, you could buy a copy machine, get CD ROM and go into business. A person can go to work in a factory and he has a minimal investment. But a farmer has to accumulate hundreds of thousands of dollars worth of equipment, which always breaks, has to accumulate hundreds of acres of land. Many farmers in this country make about $30,000 a year, the same that a person would with no capital investment.

I shall never forget the day when as an attorney for the estate, it was necessary to sell the farm to pay estate taxes. What is the definition of estate taxes? The estate is what you have after a lifetime of paying taxes. It is immoral in this country for people to have to pay taxes in order to pass the result of a lifetime of taxes on to their children. The immorality is no more expressed than in the agricultural community of this country.

I don't know how many of you have seen children crying at an auction sale when somebody is bidding low dollar on the John Deere combine, or bidding low dollar on a forced sale on real estate in order to pay the damn Government. It is outrageous. That stench of estate taxes has gone through the Republican administration and Democrat administration, and everybody thinks that estate taxes are for the rich, and they aren't. They aren't.

One of the reasons we have diminishing farmers in this country is that it is no longer available to buy land and not practice on to your children. I practiced estate planning, and we know all the cute tricks with the Q-tips and IMB policies, and people buying insurance premiums, putting ownership in the hands of another person, not even able to afford their utility bills and the bills to pay own their combines, just to pay an insurance premium all for the purpose of nothing, but a legal fraud. That is what the estate tax is.

I swore if I were ever in a position to do something about it, to help out the small farmer and the small rancher and the small business person, I would do that. But there are very few people here—in fact, and the contract only asks for $600,000 to be raised to $750,000. When farms were grossly overinflated back in the early 1980's, you know what happened? Some of that land went to $3,000 an acre in the State of Illinois. When the last, the survivors died, when ma and pa died, it didn't take much to go over $600,000. Who became the beneficiary? The Government.

It is wrong. I don't know what the small business people can do. I don't know what the farmers can do. Maybe get on your combines and you could jam them all up here before they are sold. Maybe you could have some big protest. But I can't think of any Tax Code, anything that has to be changed more than that, and I am going to offer an amendment on the floor to completely eliminate the tax, the estate tax. I can see NFIB and the farmers organizations flood this Congress and say change that law, so we can keep our farms. I am sorry.

Chairwoman MEYERS. [Presiding.] You don't have to apologize. I can tell you feel very strongly, and that is good.

Mr. Chrysler.

Mr. CHRYSLER. Thank you, Madam Chairman. It is a new day in this Congress. As you know, I share a lot of his same sentiments. The issue really is not one or the other, which one would I like to see indexed to inflation or the limit raised. The answer really is to eliminate the tax. Businesses don't pay taxes, only people pay taxes.

Taxes on businesses are just passed along in the cost of the product. When people buy those products, then they pay business taxes as well as higher taxes on those products. We should exempt closely held businesses, farms and ranches from this estate tax, which would only take about 12 percent out of the entire amount of the estate tax that is raised. The question I have is, do you have any statistics on how many businesses are sold each year due to estate taxes?

Mr. SPENCE. I think maybe the answer, it is not a clear answer, but the answer is that most everybody who runs a business knows if they have accumulated any equity in their business, they have addressed or talked to their attorneys and accountants about their estate tax problem. There are two issues, because there are people who get trapped at the point of death and they get forced to sell their businesses or there are people who recognizing the box that they are in, adopt a strategy to get out of their businesses.

So that is my problem now. I am at that point where I am recognizing the box that I am in and I have to adopt a strategy, because it is the biggest cost of my business today is the estate tax. That is getting out of the business. The only other recourse is to come back here and ask you folks in Congress to change the law. So there are no good statistics on that, because people are doing different things and it is hard to specifically categorize why they did it.

Mr. CHRYSLER. Thank you.

Chairwoman MEYERS. Thank you.

Mr. APOLINSKY. Could I just add a footnote too that?

It is an interesting question. National Life of Vermont last year, commissioned a research project by Russ Prince and Associates, on the question of survival of family businesses. He surveyed 749 family businesses that had failed within 3 years and documented the reason for that was the drain on their working capital from the estate taxes.

Mr. CHRYSLER. Thank you.

Chairwoman MEYERS. Mr. Brownback.

Mr. BROWNBACK. Thank you, Chairman.

I appreciate that very much. I want to echo what Don had to say a little bit on this, as well. I was the Secretary of Agricultural in Kansas. I have taught agricultural law. I have written books on this subject. I have written books on farm estate planning. This is ridiculous how low this figure is, the $600,000. It was set many years ago.

People have been trying to be ingenious about how they can craft around it and give the estate to one of the other surviving spouses and then pass into the next generation. What I have seen happen in so many cases then, is that the one that does try to stay, particularly in the farm, Madam Chairman, buys it from the other

children, because they had to fracture the operation up, and then maybe—well, we had the farm depression of the early 1980's.

I saw people go through bankruptcy because they bought the farm from other siblings because of estate taxes. I just plead with the people on the panel, I think you are hearing, and I hope continue to get a very receptive ear from our side of the aisle.

But this is something that is wrong. It is hurting family farming in America, I know, for certain. We are under 2 million family farmers now, and that continues to go down because it is darn tough to accumulate the assets to be a family farm, particularly if you can only inherit $600,000.

It might not be a full farming operation. In most areas, it is not. In Kansas, it is not. If you could help us in mobilizing people to recognize just what it takes to be a small business, to be a farm and the capital that it takes so that we can get this exemption unified credit level up, up significantly. So we can continue to have family farms and small businesses. Because I think it is right at the core of continuing to have that type of agriculture, that type of small business in this country. But we are going to need the fire lit under a lot of people.

I appreciate you all coming in to testify. I hope we can really draw attention to the magnitude of this problem and what it does to us as a nation long-term, when we drive people out of small business, when we drive people out of agriculture by virtue of taxing them upon their death.

One final statement was there is an old farm saying that: A farmer lives poor and dies rich. Well, in that death, he doesn't even get that. It goes on to the Government in that operation, and I think that is wrong, and we need to change it. We need your help to get it changed, Madam Chairman.

Chairwoman MEYERS. Thank you very much, Mr. Brownback.

I have a couple of comments and questions. I don't know if you know that a bill is being introduced today to repeal the estate tax. That will be introduced by Representative Cox, and I think he had a substantial number of sponsors in the last session. But I wanted to mention that.

I also believe that there is a Ways and Means hearing tomorrow. Ways and Means is the committee of jurisdiction on this. We will pass on the point of view of small business. That is part of our role.

I am working with the Chairman of Ways and Means on this, and our role is to pass along everything that we have heard to the Ways and Means Committee for their consideration. But there is a Ways and Means hearing on this issue tomorrow.

I am going to ask a couple of quick questions and then we will adjourn the meeting.

I would like to ask, I think it was Mr. True that mentioned a buy-sell agreement. Could you explain that to me?

Mr. TRUE. Madam Chair, yes. A buy-sell agreement was—I don't think it was ever specifically authorized in the statutes, but I know it was a common tool used, because my parents started it in the 1950's, where you create a market, if you will. It is an obligation to sell and it is an obligation to buy. With that instrument, you are able to create a market, if you will, for a closely held business.

It also can be used to establish some valuation guidelines so that you know that you can plan, you can understand what is going to happen, if at such time in the future, there is going to be a transfer of management and ownership.

In 1984, my sister elected to withdraw from the business. It was a very amiable situation. She married a rancher and they went to do a different thing with their lives. In that particular circumstance, my sister, Tammy, knew what she was going to be paid for that.

We knew we had to buy it, and we did. So that was a circumstance that was a very practical type of transition of ownership. When dad passed away in June of 1994, again, because these were grandfathered prior to the 2036C adoption in 1986, we knew the circumstances, the three brothers of us, and the criteria with which we would be compelled to buy his estate out of the business. They have been successful for us thus far in our planning of succession in ownership and in management.

Chairwoman MEYERS. I noticed in one witness testimony that the moneys that are derived from the estate tax are not great, I think it was less than 1 percent of total revenue, and that it costs 75 percent of what it takes in to administer it. I am not sure whose testimony that was in.

Is that because there are means of getting around the estate tax? If that is true, it doesn't seem as if there is a good reason to have an estate tax. Why create a tax and then create all the means to evade the estate tax? Who talked about that?

Yes, sir.

Mr. APOLINSKY. I did, Madam Chairman. The reason is exactly as you allude to—the complexity. The transfer taxes consume 82 pages of the Internal Revenue Code, and over 300 pages of regulation. There is a significant staffing at the IRS devoted to estate taxes.

It is a major part of their business, so they would be stressed, if I am successful in getting it eliminated. But they could also find productive work, as could I. There are over 10,500 court cases in the estate and gift tax field. The cost of litigation for the IRS and the Department of Justice.

I do not mind handling tax litigation. I love it. It is fun. You get well paid if somebody else has done some poor planning. But that to me is another waste of money that ought to be kept in the business, focused on growing the business.

Chairwoman MEYERS. I did not realize personally that this was such an unproductive tax. I have learned a great deal this morning.

I will tell you that the hearing tomorrow morning in Ways and Means is at 10:00.

Mr. POSHARD. Madam Chair——

Chairwoman MEYERS. In 1100 Longworth, if any of you have the ability or the desire to attend.

Mr. Poshard.

Mr. POSHARD. Madam Chairman, may I ask you a question quickly.

Since I am the only Democrat who has asked any questions over here in this hearing and since there is no opposing viewpoints on the panel, may I just make a further statement for just a moment?

Chairwoman MEYERS. Absolutely, Mr. Poshard.

Mr. POSHARD. Because I consider myself to be a moderate Democrat, and I think the way some of these tax implications, and so on, that we are considering are going to break down, is that some of these things—and I can't presume to know anything definitively about it, some of these things, obviously, they are going to pass this Congress and many should. But some of them are going to be vetoed by the President, too. They are going to come back here. There is not enough folks on the Republican side to override a veto, and it is going to fall to moderate Democrats as to whether we sustain or override the President's veto, as to whether many of these things get passed.

So I have some concerns, obviously, as a Democrat, and in these proceedings, because I think some of these questions are going to fall to us in the end. I just want to pose some loyal opposition here on this. Because, to me, the most essential problem facing this country is the debt that we have incurred, the $4.5 trillion of indebtedness which this year consumes nearly 21 cents of every tax dollar and interest payment on that debt that you folks send to Washington, DC

When you combine the 46 cents of every tax dollar that goes to entitlements with that 21 cents, we are up to 67 cents of every tax dollar being spent on entitlements and interest on the debt, OK? We are running the entire discretionary side of the budget, which includes the defense of this Nation, educating our children, building our infrastructure and transportation, sewer systems, everything else, protecting our environment, science, space technology, all of these things on 33 cents on the dollar.

So before I am going to vote to exempt anybody from taxes, I have got to be sure of one or two things: First of all, whatever exemption comes along, it has got to be revenue neutral to the revenue streams that come into the Federal Treasury, because we can't afford for it not to be.

Whether there is a question of justice or tax fairness, as my good friend Don Manzullo mentioned or not, the bottom line is if we are going to take—give somebody something that is going to deplete the Treasury further and drive us farther into debt, increase deficit spending the next time around, that is an injustice to our children, too. I don't want to do that.

So I guess, Madam Chairman, my concern here is that while I understand the need—and I understand what Mr. Apolinsky and everybody else is saying, somebody has got to give us some estimates here as to whether or not this is going to be at least revenue neutral along the way, and I haven't seen any of those things yet. Hopefully, as we go through in Ways and Means, and so on, we will get some of those things.

But I heard by implication some things—because I have to be a little bit defensive here. I heard by implication some things about we need this to kick-start our competition in the international market, and so on. Gosh, darn it, our economy is doing very well today and you know, we are creating a lot of jobs. We have the largest investment right now through American companies and through multinational corporations that we have had in decades in the international market arena.

It is not as if we are not doing some things right in this country right now with respect to the business and the industrial community. We are. I don't think the approach we ought to take in order to win people like myself in the end to these issues is to, by implication or otherwise, act as though because we suddenly have a change in the Congress everything is going to be better for business and industry.

Things are pretty doggone good right now for business and industry in this country. That is not to say they shouldn't be better and it is not to say we shouldn't do some things that are more fair and just in our system. But I would hope we don't try to do this in a way that destroys our ability politically to get some of these things done in the end.

Chairwoman MEYERS. Thank you, Mr. Poshard.

I would like to say that all of the issues in the contract—and I don't carry it with me, but I have seen the score sheet on all of the issues in the contract, and I think the cost is $150 billion over a 5-year period.

Mr. POSHARD. For these particular three taxes?

Chairwoman MEYERS. For all of the contract issues. Some of them bring money in. The immigrant portion brings money in and some provisions expend money. But all of them together total about $150 billion over 5 years. The Kasich budget last year saved $176 billion over 5 years. The Republicans are determined to cut spending first and not to enact these measures unless we are absolutely certain that they are paid for.

So I would agree with absolutely everything you said, Mr. Poshard. Our first interest is in a balanced budget, and we are aiming in that direction. So we have not scored all the tax changes dynamically in the $150 billion estimate. But we think that a lot of the tax changes will stimulate business and stimulate the economy and won't be as costly maybe even as set forth in our revenue estimate.

But I would like to ask if anyone here has a comment to Mr. Poshard whose remarks are well taken.

Ms. DeDominic.

Mr. POSHARD. I am not trying to be adversarial. Don't get me wrong.

Ms. DEDOMINIC. No, I understand. Many of my best friends are Democrats, so——

Mr. POSHARD. Well, I am one of about 12 Democrats in this House that didn't even vote to exempt social security last week on the balanced budget amendment, so you know how crazy I am on this, too, I think.

Ms. DEDOMINIC. I think these matters have been debated many times by people far more articulate than I am. But I am a business person. As I told you, I bootstrapped my business 16 years ago with $2,000. So I would like just briefly to speak on behalf of the minority members of our association and the women business owners of America.

We have created jobs at an incredible growth rate, but I have to tell you honestly, we have needed to overcome many hurdles and many barriers. If we have been able to create over 11 millions jobs in this country with our arms and our legs shackled, imagine—and

I mean, that by paying taxes and trying to comply with regulatory—the cumbersome regulatory burdens that we have, the fees that we have, all the other things that business owners have to do, plus all the labor laws that business owners have to pay attention to, if we slip up, there is at least 25 different agencies that can come and smack us.

I think that one of the ways—I think we are looking at this through the wrong lens. We need to look at it to reduce the size of Government, reduce the cost of services, improve the productivity of business.

If we get the shackles off of us and we have created 11 million jobs, imagine what we can do if we have all our arms and our legs an our heads focused on creating jobs, training our employees and improving the wages that they earn because they have competitive skills.

Mr. POSHARD. Thank you.

Chairwoman MEYERS. Thank you, Mr. Arth.

Mr. ARTH. Madam Chairman, and members of the committee, speaking strictly as a taxpayer and citizen and not as a representative of any organization, we are all fooling ourselves if we can solve the problems you mentioned, Mr. Poshard, without putting that 46 cents worth of entitlements on the table.

Mr. POSHARD. Right. I agree with you.

Mr. ARTH. If we are talking middle-class entitlements, social security and Medicare, I know that I will not earn probably any return on my investment in social security. Most of you probably believe or know that as well. Let's all quit kidding each other and get on with addressing the problem, which means that virtually every dollar that the Federal Government spends has to be questioned and has to be on the table for discussion.

Chairwoman MEYERS. I appreciate the comment very much of, Mr. Arth.

Mr. POSHARD. Very true, Mr. Arth.

Chairwoman MEYERS. I also think we have stated very strongly everything is on the table except social security. Everything is on the table. Sometimes we talk about social security as if it were an entitlement. But social security is a trust fund program. It is in a little different category. No one pays into an entitlement. An entitlement is something you only take out of. People can live their entire lives, pay into social security their entire lives, and they end up maybe with $6,000 a year.

A young woman can have two children out of wedlock and earn $18,000 a year. Something is wrong with that. We are not putting social security on the table, but all of the other entitlements are going to be on the table.

Mr. Spence.

Mr. SPENCE. Oh, well, in response to the revenue question; I have always had a problem with the dynamic and the static model, because if I ran my business on a static model, I would be broke today. I have to run my business from a dynamic approach. I have to take the risk.

In the last 5 years, we—out in the West Coast, we have been involved in what we call the environmental wars, and the U.S. Forest Service was a big provider of timber to the timber industry for the

last many decades, has been withdrawn from that system. So we were confronted with the problem of how do we continue this business, how do we maintain the employment in our communities?

Do we accept the fact that all of a sudden there has been a change here and then do we stop running? Then do we trigger the Government programs that were put into place for job retraining, or social networks which are there, or do we come up with strategies which are investment-oriented and then do we struggle to find a successful way to overcome the change?

We have taken the approach that we as business people were going to modify our business and we were going to take the chance to invest money and try to find a way to deal with that, rather than relying on what we felt would be inbred social programs that would actually stagnate our people and destroy their pride in those communities.

So far, we have been able to do it and we have been spending the kind of money that I have been talking about in this hearing, Madam Chairman. We hope we can continue to do that.

The main obstacle right now that we see to being able to continue that process is the estate tax, because it puts us at such jeopardy on putting that capital in front of the tax system.

Chairwoman MEYERS. Thank you very much, Mr. Spence.

Mr. Flake has just joined us.

We said that we would conclude the hearing at 12:30, Mr. Flake, and so I will turn it over to you.

Mr. FLAKE. I will just ask unanimous consent to have my remarks and the questions included in the record.

Glad I came at a time when I heard my speech being made by somebody else about investments, as opposed to social programs. I welcome an opportunity to talk further with you about that.

Thank you very much, Miss Myers.

[Mr. Flake's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you, Mr. Flake.

I want to thank all of our witnesses and those members of the committee who stayed clear to the end. We do have a lot of conflicts here and I am sorry it was so disruptive this morning, and thank you all.

We are adjourned.

[Whereupon, at 12:28 p.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

STATEMENT OF THE HONORABLE DON MANZULLO

HEARING BEFORE THE SMALL BUSINESS COMMITTEE

ESTATE TAX REFORM

JANUARY 31, 1995

Madame Chairwoman, thank you for holding hearings on this timely topic today. The time to end the confiscatory estate or death tax is long overdue.

Get this, Madame Chairwoman. A person pays taxes all during his or her life -- gas tax, sales tax, local tax, state income tax, federal income tax, and Social Security "contributions." Death is as sure as taxes. But one would think that one "benefit" of death, in addition to securing eternal peace, is the cessation of taxes. Wrong!

The estate tax is a tax on all the property a person accumulates after a lifetime of paying taxes on the same assets. I practiced law in a small country town in northwestern Illinois for nearly 22 years. I'll never forget the day I advised a family that they had to sell one of the two family farms just to pay the estate tax. You explain to the children who want to farm that property that the land is no longer there for them.

I could practice law with a careful investment of less than $30,000 for books, equipment, office space, etc. and make a good living. A family farmer has to have hundreds of thousands of dollars in assets to make the same salary as a person who works in an office or factory and have no capital investment outside of their education.

Under the present estate tax law, there is an unlimited marital deduction, which means one spouse can pass on the entire estate to the other with no tax consequences. The estate tax occurs only upon the passing of the survivor. Sure, as an attorney, I drew those fancy A and B trusts to minimize the tax bill. But, eventually, the horrible tax comes.

The government brings in about $12 billion in revenue from estate taxes. Business assets represent approximately 12 percent of that total -- $1.4 billion out of a $1.5 <u>trillion</u> budget. The Contract with America says we should increase the $600,000 deduction to $750,000 and then index it for inflation thereafter. I say abolish this unholy confiscatory tax, as least with respect to the family farm and ranch.

I look forward to the testimony of the witnesses here this morning to see how we can rectify this issue as soon as possible. Thank you, Madame Chairwoman.

SMALL BUSINESS COMMITTEE

U.S. House of Representatives

Jan Meyers (R-KS)

FOR IMMEDIATE RELEASE
JANUARY 31, 1995

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STATEMENT OF CHAIR JAN MEYERS

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

- FULL COMMITTEE HEARING -

"SMALL BUSINESS AND THE CONTRACT WITH AMERICA:
ESTATE TAX AND THE FAMILY BUSINESS"

The Committee will come to order:

Good Morning Ladies and Gentlemen. Continuing our series of hearings devoted to Tax Policy and Small Business, this morning we will be focusing on the estate tax and the family business.

As you know, estate taxes are a critical issue for many small businesses in this country. The continuity of a business into the second and third generation of a family is not only vital to our economy but an important aspect of American society -- building something for our children and their children. In recognition of this, the "Contract with America" contains a provision which seeks to address the important issue of estate tax. Section 12001 of H.R. 9, the "Job Creation and Wage Enhancement Act," increases the unified estate and gift tax credits. These provisions would reduce the disastrous results of taxes on family-owned businesses.

The concept surrounding the estate tax, or sometimes referred to as a death tax, has ancient roots beginning as early as 700 B.C. in Egypt with a 10% transfer tax on property. Moving swiftly ahead in history to 1916, the year the estate tax was enacted in the United States, the exemption was $50,000, and by 1975, it was only $60,000. Additional increases in the exemption were enacted in 1976 and 1981, with the exemption increasing to $175,625 in 1981 and to $600,000 in 1987. Although the exemption has increased somewhat more than the rate of inflation since

1981, the exemption has declined in real "dollar value" terms since 1987. An exemption of about $800,000 in 1995 would be required to maintain the real exemption at its 1987 level.

As you know, the current estate tax exemption is $600,000 which means that up to $600,000 of the wealth owned by a decedent at death is not taxed under the estate and gift tax. This $600,000 exemption is equivalent to a unified estate and gift tax credit of $192,800. However, enacting the provisions in the Contract With America would not only increase the estate tax exemption from the current $600,000 amount incrementally to $700,000, 725,000, and $750,000 in 1996, 1997, and 1998, respectively. Beginning in 1998, the $750,000 would be adjusted for inflation. The unified transfer tax credits for these exemption levels would equal $229,800 in 1996, $239,050 in 1997, and $248,300 in 1998.

The Contract's proposal would reduce the number of estate tax returns but not significantly. Regardless, the proposed tax relief may not reach those estates more likely to have liquidity problems therefore many times forcing family members to sell their business assets to pay the estate tax.

I strongly support the provisions in the Contract and believe it is a good start to protecting the lifetime investments of the small business family and reducing the estate tax burden overall. I look forward to your testimony.

Small Business Council of America

TESTIMONY OF

SMALL BUSINESS COUNCIL OF AMERICA (SBCA)

BEFORE THE

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

JANUARY 31, 1995

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STATEMENT OF HAROLD I. APOLINSKY ON BEHALF OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON SMALL BUSINESS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

ON ESTATE, GIFT AND GENERATION-SKIPPING TAX REFORM

JANUARY 31, 1995

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President - Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, I have taught estate planning and estate, gift and generation-skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on estate, gift and generation-skipping taxes.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation-skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1986 White House Conference on Small Business recommended eliminating estate and gift taxes on the transfer of small business assets to family members. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-Seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

- The estate tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth". Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. The expense of administering this system probably offset 75% or more of the revenue.

- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

- Australia repealed their estate and gift tax laws in the mid-1970's. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

  The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets

were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed.

- If you factor the significant expense in collecting these taxes and the income tax when assets were sold, the repeal may be revenue neutral.

- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

Some of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 (attached as Exhibit "D"), was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital!

It is contrary to the best interest of my tax practice, my teaching, and my firm (we have 6 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. It is the right thing to do to help grow family businesses, provide jobs and encourage the entrepreneurial spirit needed for small businesses to become large businesses.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

   1. Debts and expenses.
   2. Marital (assets left to spouse if citizen).
   3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800*)

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

* This is tax on $600,000 taxable estate.

EXHIBIT "B"

PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.

B. Legislation was also introduced but not enacted in the 102nd Congress would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:

(1) The business must be worth less than $50 million.

(2) The business must comprise at least 40 percent of the decedent's estate.

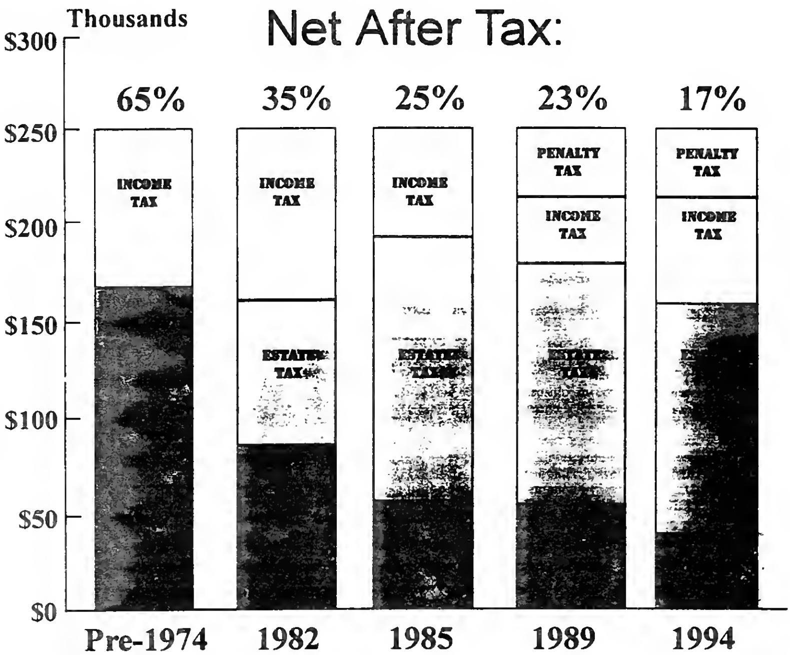
(3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.

C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.

D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments (H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).

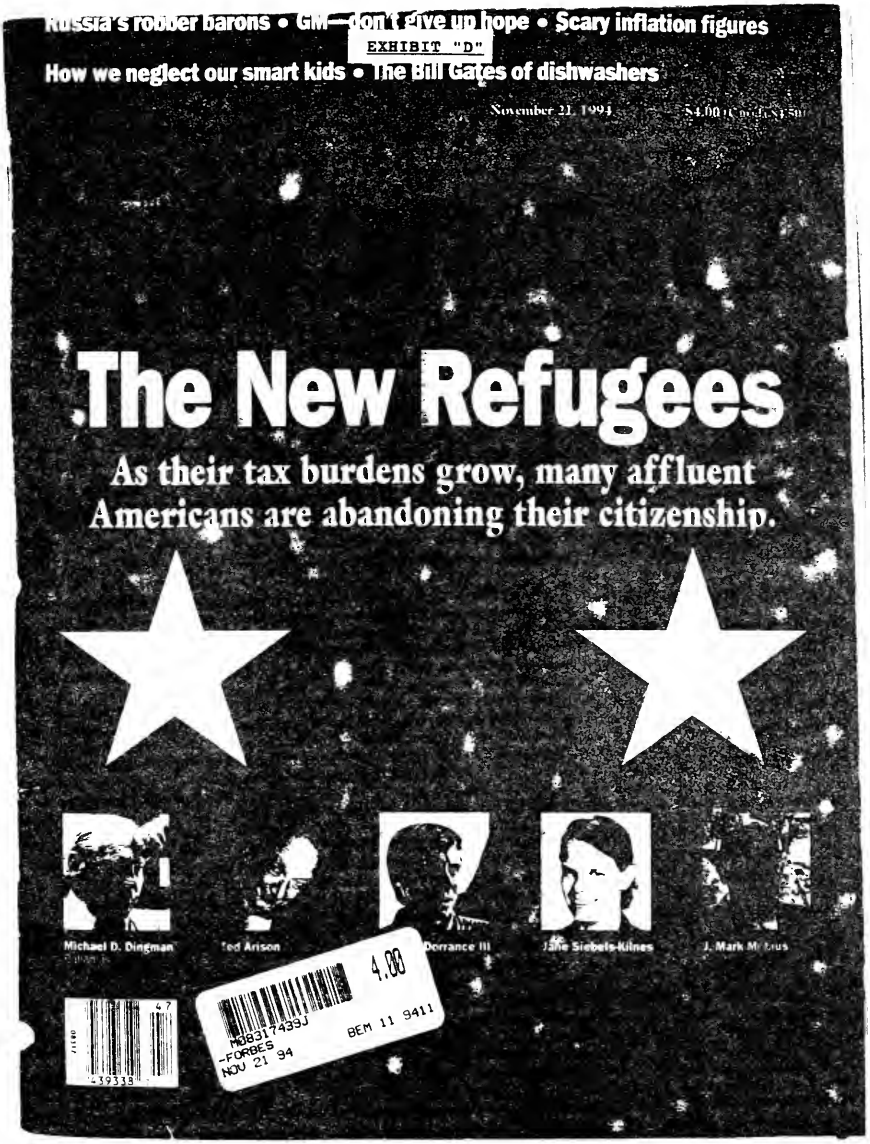
EXHIBIT "C"

HISTORY OF QUALIFIED PLAN TAXATION AT DEATH



Breakdown of Taxes

(Assuming top marginal tax bracket)


Russia's robber barons • GM—don't give up hope • Scary inflation figures
EXHIBIT "D"
How we neglect our smart kids • The Bill Gates of dishwashers
November 21, 1994
The New Refugees
As their tax burdens grow, many affluent Americans are abandoning their citizenship.
Michael D. Dingman
Ted Arison
Dorrance III
Jane Siebels-Kilnes
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Many Americans are giving up their citizenship. Before condemning them, we might well ask ourselves whether the U.S. tax system isn't killing the goose that lays our golden eggs.

The new refugees

By Robert Lenzner and Philippe Mao

Michael Dingman may easily be able to pay for his new 15,000-square-foot home with the tax money he saved by giving up his American citizenship.

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

–Judge Learned Hand

"I TALK TO A new client interested in expatriating every week. Many people can't pay the federal tax rate and live in the style they want." So said Francis Mirabello, the head of the personal law department at the Philadelphia office of Morgan, Lewis & Bockius, speaking at a Bermuda conference on offshore money early this fall.

Expatriating? Give up U.S. citizenship? Who in his right mind would give up his U.S. citizenship? Lots of people. You could practically fill a Boeing 747 with well-heeled U.S. citizens who have taken on foreign citizenship rather than submit to what Learned Hand called "enforced exactions" at a level that amounts to virtual confiscation. The exodus may speed up under an Administration that campaigned for office on a tax-the-rich platform.

In 1981 Ronald Reagan lowered taxes. The following year not a single American gave up his citizenship. In 1993 the expatriate community grew by 306 names.

The expatriates of recent years have included:

Michael Dingman, chairman of Abex, and a Ford Motor director. Dingman is now a citizen of the Bahamas and lives there.

Billionaire John (Ippy) Dorrance III, an heir to the Campbell Soup fortune. Dorrance is now a citizen of Ireland and lives there as well as in the Bahamas and Devil's Tower, Wyo.

J. Mark Mobius, one of the most successful emerging market investment managers. Born a U.S. citizen, Mobius has the German citizenship of his ancestors and lives in Hong Kong and Singapore.

Merrill Lynch's Cayman Islands trust bank holds its securities in Switzerland, does its accounting in Singapore and is administered from the Isle of Man. Its clients live all over the world.

Kenneth Dart, an heir to Dart Container and his family's $1 billion fortune. He is a citizen of Belize and works in the Cayman Islands.

Ted Arison, founder of Carnival Cruise Lines. He kept Israeli citizenship and now lives there.

These newer emigrants join others of longer standing, including Robert Miller, the co-owner of Duty Free Shoppers International Ltd. Miller has a British passport obtained in Hong Kong, though he was raised in Quincy, Mass.

The U.S. is virtually the only country in the world that imposes significant income and death taxes on the worldwide income and assets of every citizen, even if the citizen is domiciled elsewhere. Even Canada, semisocialist, did away with estate taxes.

"Expatriation has been called the ultimate estate plan," says William Zabel, senior partner of Schulte Roth & Zabel, one of the nation's foremost authorities on trusts and estates, and author of the upcoming book *The Rich Die Richer—And You Can Too.*

The arithmetic is simple and brutal. A very rich Bahamian citizen pays zero estate tax; rich Americans—anyone with an estate worth $3 million or more—pay 55%. A fairly stiff 37% marginal rate kicks in for Americans leaving as little as $600,000 to their children. The marginal rate—what you pay on an additional dollar of assets—ranges upward from there to 60%. You get a credit for some or all of your state inheritance taxes, but your combined rate will still be in this range, or higher.

There are huge potential income tax savings, too, in giving up U.S. citizenship. St. Kitts-Nevis and the Cayman Islands, among others, levy no income taxes. Little wonder so many of the expatriate Americans have gone to the Caribbean for a year-round suntan.

Not that living in the Bahamas is any great sacrifice. Michael Dingman is building a 15,000-square-foot home at the exclusive Lyford Cay club in Nassau that will include a dock for his personal yacht. Cost: more than $10 million, but—who knows?—he might save more than that much in taxes.

The heirs of John (Ippy) Dorrance III, the Campbell Soup heir, won't have to pay Uncle Sam the maximum bite of 55% on the 26.7 million shares of Campbell Soup that make up most of his $1-billion-plus fortune. His new fatherland, Ireland, levies a 2% estate, or probate, tax. In any event, Dorrance doesn't escape the full federal income taxes. There's a U.S. withholding tax of 30% on the $30 million he gets in dividends every year from Campbell.

Many of these expatriates agonize over the decision, however. "I have serious reservations about expatriation for patriotic and practical reasons," says tax expert Zabel. "It is extraordinarily difficult for Americans to get back their citizenship once it is given up. To get it back you have to start like any other nonresident alien, with a green card, and go through the naturalization process.

"Before expatriating I make my clients consider all the limitations on loss of citizenship—like giving up the ability to travel to the U.S. more than 120 days a year."

But losing that American passport isn't as hazardous as it once was. Profligate government policies are steadily eroding the value of the U.S. dollar, making overseas investments increasingly preferable for the wealthy. Investments in emerging markets look increasingly attractive. The end of the cold war means wealthy Americans can live in many developing nations safely. Global communication and jet travel facilitate an offshore lifestyle. What with computers and cable TV, you can be as well informed, and as quickly, living in Antigua as in New York City.

It certainly seems that way to Frederick Krieble, a director and former treasurer of Loctite Corp., the Rocky Hill, Conn. manufacturer of sealants and adhesives. Krieble, whose father, Robert, was formerly Loctite chairman, moved to Turks and Caicos Islands, where he runs an investment company. Krieble owns almost 1 million shares of Loctite, worth over $43 million.

"It's 85 degrees, but the market's down 35 points," Krieble told FORBES recently. When he heard we wanted to discuss the subject of expatriation, Krieble clammed up. "I don't wish to discuss that. Have to run now."

Yes, it's a bit embarrassing, but consider the consequences: decimation of your estate and huge reductions in your aftertax income.

Thus many money managers, senior executives and self-made entrepreneurs are on the phone quizzing their lawyers and accountants about how to leave the high-tax U.S.

Jane Siebels-Kilnes, a vice president of Templeton, Galbraith & Hansberger, in Nassau, told FORBES she was "following in the footsteps of Sir John Templeton," who gave up his U.S. citizenship in 1962 and moved to Nassau. Thus when Templeton sold his mutual fund management company in October 1992, he may have saved more than $100 million in capital gains taxes. Templeton, an extremely generous and public-spirited man, gives most of his money away. Apparently he wants to decide who gets the benefits rather than letting Donna Shalala or Mario Cuomo decide.

Siebels-Kilnes became a Norwegian citizen this year and moved her residence from Fort Lauderdale, Fla. to Nassau. "I've spoken to a number of hedge fund managers who are thinking of giving up their citizenship. It may be better to be offshore running offshore money before American authorities clamp down on the advantages," says Siebels-Kilnes.

A hot spot: St. Kitts-Nevis. All it requires is owning $150,000 worth of local real estate and paying $50,000 in fees, and presto. St. Kitts-Nevis levies neither a personal income tax nor an estate tax.

Top executives of midwestern industrial companies nearing retirement are considering expatriation as a way to ensure a high standard of living in a comfortable environment.

Is it greed alone that impels these citizenship changes? Not necessarily.

"These people love to challenge all the rules, even recognizing they may isolate themselves," says Carol Caruthers, a partner of Price Waterhouse in St. Louis. "We are doing preliminary planning for a few of them."

Expatriation is a fairly easy choice for many wealthy Americans who hold dual citizenship—as Mobius already did—and whose wealth is heavily concentrated abroad anyhow. "Since they may inherit these assets, a planning opportunity might be to give up U.S. citizenship in order to avoid taxation on assets and income that have no connection to the U.S.," says Robert C. Lawrence III, a Cadwalader Wickersham & Taft partner in New York who is advising on several such expatriations.

You'll need an ace attorney. If the Internal Revenue Service suspects you are renouncing your citizenship to avoid taxes, it will try to tax your holdings for another ten years, no matter where you live. All the IRS need establish is that it is reasonable to believe you gave up citizenship to avoid taxes. Then, the burden of proving the move was *not* for tax reasons falls on the former citizen.

But whatever the drawbacks, many nations put out the welcome mat for tax-averse Americans.

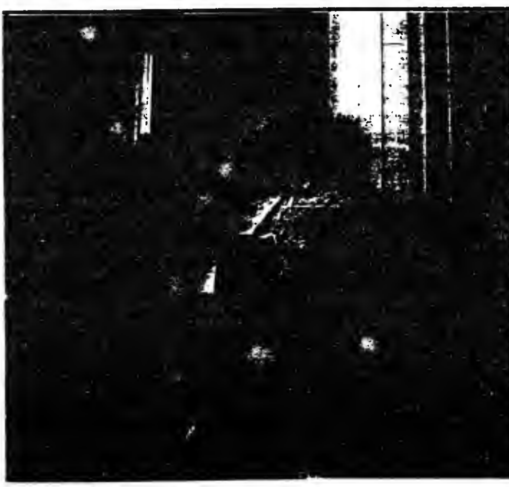
Lawyer Mirabello, who is working on six expatriations, is changing citizenship for a superwealthy Chinese-American whose headquarters is in Hong Kong. He has never set foot in the U.S. and wants to avoid estate taxes when he passes the empire to his children.

Some of Mirabello's clients are considering becoming Irish citizens. What does that require? Certainly no hardship, given what a pleasant place Ireland is for those with money. They need only buy a home there and reside there at least part of the year.

Why Ireland? An Irish passport lets its holder travel hassle-free in any member of the European Union. It also has more panache than a passport from Belize or St. Kitts, two small tropical outposts. And, Dublin is being developed as a global money center with tax advantages for individual and corporate investors.

How do you get an Irish passport? It should be fairly easy for the rich. New regulations will probably require a $1.6 million investment in a job-producing operation like the reforestation of an area or modernization of a shipbuilding concern. This is the so-called business migration scheme, administered in Dublin by the Department of Justice. Its guidelines are currently being reexamined for political reasons.

Another attractive destination is Switzerland. "You can pretty well ne-



Sir John Templeton at Lyford Cay

He gives most of his money away. He can do it better than a politician.

[redacted]

The heirs of Ippy Dorrance will only pay a 2% estate tax on his more than $1 billion in Campbell Soup shares.

gotiate your own private agreement with a Swiss canton about your annual income taxes," asserts Lawrence.

Can an affluent American keep the politicians at bay without sacrificing citizenship? It's not easy. Wealthy people hold over $2 trillion in offshore accounts from Zurich to the Cayman Islands. No doubt some of these accounts are held by Americans who—illegally—omit mention of them on their tax returns.

Merrill Lynch, like all major investment firms, has a piece of this business. Merrill will not accept offshore accounts from U.S. citizens, but it is eager to service foreigners.

"Offshore money is growing faster than any other part of the financial services industry. It's multiplying at a double-digit rate of growth," says Nassos Michas, head of Merrill Lynch's private banking division. Merrill's trust bank in the Caymans, with assets growing at over $100 million a month, has almost $5 billion of wealthy individuals' holdings.

Actually, the Caymans trust is just a file for legal purposes. Merrill's banks in Geneva, New York and London hold the securities. The accounting is done in Singapore; the administration is done on the Isle of Man, famed for its trust business.

Wealthy Europeans, Latin Americans, Asians and Middle Easterners are Merrill's principal clients here. They want to buffer their fortunes against expropriation, political unrest, economic instability, angry first wives, kidnapping, family members, creditors and potential litigants.

Wealthy Europeans have expatriated their money to safety ever since the French Revolution, when they began hiding it in Switzerland.

When the Germans occupied the Netherlands in 1940, this activated a trust instrument transferring ownership from the homeland to a trust at a U.S. bank. In Europe, where the pounding of marching feet and air raid warnings are of recent memory, use of such trusts was common, at least up until the collapse of the Soviet Union.

Today many wealthy Kuwaitis have trusts offshore to protect their fortunes from Saddam Hussein. The rich in Latin America, Southeast Asia and the Middle East remember that it was only yesterday that their countries were ruled by thieving populists or arbitrary soldiers.

What is new is that Americans are beginning to feel the same sort of residual uncertainty about their possessions. They see courts eroding property rights. They read about bureaucrats who talk about "tax expenditures" when referring to that part of your earnings that they permit you to keep. They are subjected to retroactive taxation under the Clinton "deficit reduction bill." They live in a society that changes the tax rules so frequently that long-term planning is almost impossible.

So they consult legal experts like Cadwalader's Lawrence, who is an authority on generational and international planning, including the use of trusts, and taxation. "They want to sequester, organize and protect the privacy and maintenance of their wealth, plus the freedom to transfer it as they wish," says Lawrence.

But how, short of leaving for some sand dune in the Caribbean?

There are several clever strategies you can use to minimize the future tax bite on your estate *(see box, opposite)*, but the fact is that Congress has done a very thorough job of plugging chinks in the tax code. Parking assets abroad or setting up holding compa-

Lawyer William Zabel
"It is extraordinarily difficult for Americans to get back their citizenship once it is given up."

Avoiding confiscation

SHORT OF RENOUNCING citizenship, how do you protect the family fortune from confiscation by the tax code writers in Congress and in the U.S. Treasury?

The first, and easiest, tax-saving maneuver is to give the money away while alive. If the heirs are young or irresponsible, you can put the gift in a trust and get the same tax advantages.

There are two advantages to gifts over bequests. One is that the first $10,000—per year, per recipient, per donor—is free from gift tax. If both you and your spouse give for a long time and you have many heirs, that exclusion can make a serious dent in your estate. With five heirs, two donors and 20 years to make the transfers, you can get $2 million out of your estate scot-free.

The other advantage is that the gift tax is somewhat lower than the estate tax. The two taxes use the same rate schedule, but the gift tax is calculated in a way more favorable to the taxpayer. Say you give $1 million to a grandchild when you are in the 60% bracket for federal gift tax. (That rate applies when your cumulative gifts, after the exclusion, are between $10 million and $21 million.)

The total cost of the gift will be $1.6 million—$1 million to the grandchild, $600,000 to the IRS. But at your death, that $1.6 million would be divided $960,000 (60% of $1.6 million) to the IRS, only $640,000 to the grandchild.

Caution: If you die within three years of making a gift, your taxes will be recalculated to negate the advantage of giving over bequeathing.

Another defensive maneuver is the grantor retained annuity trust (FORBES, *Jan. 31*). You transfer your business to a trust whose beneficiaries are your heirs. Out of the trust you carve yourself an annuity. The trust pays your annuity out of business earnings.

"It's a combination of solutions," says New York lawyer Richard Covey. "I find most wealthy people outside New York don't know about these tricks."

You figure the discounted present value of the annuity you retained, and subtract this amount from the value of the business in order to arrive at the value of the gift. The annuity gives you income while keeping your taxable gift to a minimum.

Business owners are also availing themselves of the "minority discount" rule (FORBES, *Mar. 1, 1993*). For example, your software firm is worth $10 million. Carve it up into ten shares and give one share each to ten heirs. Each share may be worth only $700,000 on a gift tax return, because no outside investor would want to be a minority owner in a family business.

If the family heirloom is a house, a variation on the GRAT may work well. You give your residence to your heirs, retaining the right to live in it for a specific period (FORBES, *June 24, 1991*). Again, the carve-out reduces the value of the gift.

Another innovation is the dynasty trust. Each grandparent puts $1 million worth of property in a trust in South Dakota for the benefit of grandchildren and great-grandchildren. Why South Dakota? Because it permits trusts to last in perpetuity; most states allow them to last no more than 21 years after the death of anyone now living. Why only $1 million? Because if you transfer more than that you will get hit with a punitive "generation skipping tax."

Note that a dynasty trust doesn't relieve you of the usual gift tax. It might, however, let you keep an asset in the family for a long, long time. The asset is hit with a transfer tax only once, when you set up the trust, rather than again and again as each generation passes on.

"There's no one device to solve all the problems. It's a combination of solutions," says Richard Covey, a partner at Carter, Ledyard & Milburn in New York. "I find most wealthy people outside of New York don't know about these tricks."

What about life insurance? The inside buildup of assets gets passed on to your heirs tax-free, but the premiums you pay must be reported as gifts. Life insurance is somewhat overtouted as an estate tool but it does have its advantages, especially if you die before your time.

You also can buy a tax-deferred annuity from a foreign life insurance company, typically German or Swiss. If the annuity is fixed rate and denominated in deutsche marks or Swiss francs, it may protect your nest egg from a deteriorating dollar (FORBES, *June 20*). You may also opt for a variable policy that is invested in stocks or mutual funds.

But you won't save taxes unless your estate administrator is willing to commit a felony by omitting it. So the main legal benefit of these overseas insurance policies appears to be that they may—repeat, may—be beyond the reach of creditors.

For a while the very wealthy were able to defer tax on portfolio profits by investing in overseas funds that had a majority of shares held by foreigners. But the 1986 tax act put a stop to this game.

After the 1986 crackdown, the main thing that offshore funds can do for you is give your fund manager more flexibility in trading. Domestic funds must be diversified, must avoid getting too much of their profits from short-term trading, and have limits on leverage. Foreign funds escape these rules, says Joel Adler, a partner in Sutherland, Asbill & Brennan in New York.

The bottom line is that there isn't much that wealthy Americans can do to protect their assets from a covetous state. Which explains, if it doesn't excuse, the drastic step taken by more and more people of giving up their U.S. citizenship.

–R.L. and P.M. ■

Even foreigners have to go to great lengths to avoid a grab by the U.S. tax authorities. If they own U.S. securities, they should vest ownership in an offshore legal structure.

ties will not get you out of the U.S.' steep income and estate tax rates. You really have to give up citizenship to get a big tax savings.

It's easier for foreigners who have property in the U.S. to avoid the worst of American taxation, but even for them there are pitfalls. They must pay U.S. estate taxes on assets held in the U.S. unless they safeguard them by means of an offshore legal structure. Only certain fixed-income investments are immune from the IRS.

A foreigner can shelter his U.S. assets in the following way: Set up a trust outside the U.S. in some tax-advantaged locale, such as Bermuda, the Cayman Islands or the British Virgin Islands. "The foreign trust must own an underlying holding company, called a private investment company (PIC)," Lawrence says.

"The PIC opens an investment account in the U.S. Otherwise, a foreign individual who has a stocks-and-bonds portfolio of U.S. companies would be subject to U.S. estate tax. If the securities are owned by a true foreign corporation, the individual is not subject to the estate tax. The foreign corporation acts like a shield to the estate tax."

The IRS can't be happy about these paper-shuffling arrangements. Indeed, Lawrence is afraid it may crack down on them. But before you cheer at the prospect of making them furriners pay up, remember this: The U.S. needs foreign capital because we don't save enough. We must compete for that capital with lots of other places. Treat the capital shabbily and it can go elsewhere.

"I'm afraid that foreign capital may be scared away from the U.S. because of taxes and the complexity of our regulation," Lawrence warns.

It could happen, Lawrence insists. He points to the Foreign Investment in Real Property Tax Act, passed in 1980, which forces foreigners to pay a capital gains tax when they sell real estate in the U.S. We shudder to think what would happen to the U.S. stock and bond markets if foreign paper holdings were similarly taxed.

It will come as a shock to many people to learn about the growing band of expatriates. But it is not unpatriotic to remind Americans that ours is no longer the only show in town as a place to invest. At a time when we urge developing countries to cut taxes and make capital more secure, a lot is happening to make it less secure and more heavily taxed at home. Those who give up their citizenship to escape Clintonomics and wealth redistribution are only the extreme part of a worrisome trend. ■

Lawyers Robert Lawrence, Francis Mirabello

"You can pretty well negotiate your own private agreement with a Swiss canton about your annual income taxes."

HAROLD I. APOLINSKY

Curriculum Vitae

Occupation

Senior member of the Birmingham, Alabama law firm of Sirote & Permutt, P.C. Practices in the areas of health care law, including structuring health care delivery systems; estate planning and estate administration; tax planning for professionals; and mediation.

Education

Received a B.S. Degree with Honors from the University of Alabama, J.D. Degree with Honors from the University of Alabama School of Law, and Masters of Law from New York University School of Law. Editor-in-Chief of the Alabama Law Review and Teaching Fellow at New York University. Adjunct professor of tax law at University of Alabama School of Law, 1973 to present; and Cumberland School of Law, 1976 to present.

Selected Professional Activities and Honors

Past-Chair of the Personal Service Organizations Committee of the Section of Taxation of the American Bar Association, 1982-84; Chair of the Alabama Law Institute Committee to Modernize the Professional Corporation Law, 1983; ABA Section of Taxation representative to the Southeast Region Tax Liaison Committee, 1987-88; Vice-chair of the Regional Liaison Meetings Committee of the Tax Section of the ABA, 1989-90; Chair of the Regional Liaison Meetings Committee, 1991-93.

Author of a number of articles for various publications, including The Tax Lawyer and Life Association News. Editor and contributing author of Tax Planning for Professionals, published by Warren, Gorham & Lamont, Inc. 1985.

Past-President and Regent of the American College of Tax Counsel, 1980-87; Member of the Commissioner of Internal Revenue Service Advisory Group, 1987; Fellow, American College of Trust and Estate Counsel 1989-__; Chair of the National Planned Giving Sub-Committee of the American Heart Association, 1987-89; Vice President/Governmental Affairs and member of the Board of Directors of the Small Business Council of America, Inc., 1988-90; Member of the Board of Directors and President (1990) of the Estate Planning Council of Birmingham, Inc., 1983-1991; Chair of the Small Business Council of America, Inc., 1991-1993; Board of Directors, National Association of Estate Planners and Councils, 1993-__. Listed in The Best Lawyers in America (1995-1996) for Tax and Estate Planning.

Selected Civic Activities and Honors

Member of the Board of Directors of the Rotary Club of Birmingham, 1985-1991; President of the Alabama Symphony Association, 1992-93; Member of the Board of Directors of the Children's Aid Society, Birmingham, 1981-87; Past-President, Children's Aid Society Foundation, 1987-90; Past-President and member of the Board of Directors of the Jewish Community Center; Past-President and member of the Board of Directors of the Birmingham Jewish Foundation; Member in the Newcomen Society. Recipient of the Walter P. Gewin Award for Outstanding Service to the Alabama Bench and Bar in Continuing Legal Education, 1987.

Harold I. Apolinsky
Curriculum Vitae (continued)

Lecturer for the following, together with papers presented (1982-current):

Federal Tax Clinic-November 1994 "Physician Organizations: Choices in Restructuring Medical Practice in this Era of Change".

Tax Seminar-November 1994, "Estate Planning Ideas for 1995 -- An Overview" and "Retirement Plan Beneficiaries -- Primary: Spouse, Secondary: Charity".

Tax Club-November 1994. "Succession Planning for Family Businesses".

CPA Seminar-September 1994. "Seed the Family Charitable Bank Account with Retirement Funds".

American Law Institute/American Bar Association-February 1994, "Physician Organizations: Choices in this Time of Change".

Harvard Medical School, The Children's Hospital of Boston-October 1993, "Physician's Choices in This Time of Change".

Baptist Medical Center-October 1993, "Presentation to Physicians: Choices in This Time of Change".

Medical Center East-September 1993, "Presentation to Physicians: Choices in This Time of Change".

Columbus Jewish Foundation-November 1993, "Estate Planning for 1994: An Overview".

Alabama Federal Tax Clinic-November 1993, "A Succession Plan is a Must".

Sirote & Permutt, P.C., Management and Collection of Medical Accounts Seminar-September 1993, "Integrated Delivery Systems: A Response to Clinton's Health Care Reform".

Institute of Management Accountants (IMA) Seminar-July 1993, "A Succession Plan is a Must".

Heart of America Tax Institute-May 1993, "Succession Planning".

Harold I. Apolinsky
Curriculum Vitae (continued)

Atlanta Chapter, Chartered Life Underwriters-May 1993. "Succession Planning".

National Life of Vermont, REACH Seminars-March 1993, "Succession Planning".

American Law Institute/American Bar Association-February 1993, "Succession Planning".

Tennessee Federal Tax Institute-December 1992, "Valuing the Family Business at Death: The Last Planning Opportunity to Save the Client".

Alabama Law Institute for Continuing Legal Education-December 1992, "Charitable Giving".

Jewish Federation and Endowment Fund of Nashville-November 1992, "Charitable Giving Opportunities".

Mississippi Tax Institute-October 1992, "Estate Planning for the '90s".

Heart of America Tax Institute-October 1992, "Estate Planning for the '90s".

Georgia Federal Tax Conference-June 1992, "Estate Planning Ideas for 1992--An Overview".

Georgia Federal Tax Conference-June 1991, "Intriguing Estate Planning Issues".

Chattanooga Estate Planning Council-March 1991, "Chapter 14: Special Valuation Rules".

Tennessee Federal Tax Institute-December 1990, "Valuing the Family Business at Death: The Last Planning Opportunity to Save the Client".

Chattanooga Estate Planning Council-November 1990, "New Chapter 14: Obstacle to Passing Family Business".

Chicago Estate Planning Council-October 1990, "Rabbi Trusts--Deferred Compensation".

Georgia Federal Tax Conference-June 1990, "Legislative Developments".

Tennessee Federal Tax Institute-December 1989, "Valuation Strategies and Planning".

Heart of America Tax Institute-October 1989, "Valuation Strategies and Planning".

Chicago Estate Planning Council-October 1989, "Rabbi Trusts--Deferred Compensation".

Harold I. Apolinsky
Curriculum Vitae (continued)

Southern Federal Tax Institute-September 1989, "Charging it to the Company".

Georgia Federal Tax Conference-June 1989, "Helping Clients Secure a Provision in the Tax Law".

International Association for Financial Planning-March 1989, "Estate Planning Opportunities for the Closely-Held Business".

American Association of Life Underwriters-March 1989, "Insuring Charitable Gifts".

Alabama Profit Sharing Council-December 1988, "Transition Rules--Special Provisions in the Tax Law".

Alabama Society of CPAs-December 1988, "Certain Estate Planning Provisions (TAMRA)".

University of Alabama Federal Tax Institute-November 1988, "Probable Changes in the Tax Law".

Cumberland Institute for Continuing Legal Education-November 1988, "Life Insurance Planning Opportunities".

Southern Federal Tax Institute-October 1988, "Valuation Planning".

Associated Accounting Firms International-October 1988, "Transition Rules--Special Provisions in the Tax Law".

Birmingham Tax Club-September 1988, "Transition Rules--How to Help a Client Secure a Special Tax Provision".

American Heart Association-August 1988, "Charitable Giving".

Georgia Federal Tax Conference-June 1988, "Current Developments in Estate and Gift Tax Planning".

American Association of Life Underwriters-March 1988, "Planning Considerations for Life Insurance".

National Association of Accountants-December 1987, "Taxpayer Bill of Rights".

Harold I. Apolinsky
Curriculum Vitae (continued)

Cumberland Institute for Continuing Legal Education-November 1987, "Charitable Giving Opportunities".

Million Dollar Round Table-July 1987, "New Opportunities for Charitable and Family Giving After TRA '86".

Georgia Federal Tax Conference-June 1987, "Current Developments in Estate and Gift Tax Planning".

University of Alabama Federal Tax Institute-November 1986, "Estate Planning".

Boy Scouts of America-November 1986, "Charitable Giving".

Heart of America Tax Institute-October 1986, "Creation, Care & Feeding of Professional Corporations".

American Heart Association-October 1986, "Charitable Giving".

Georgia Federal Tax Conference-June 1986, "Current Developments in Estate and Gift Tax Planning".

Tennessee Federal Tax Institute-December 1985, "Changes Affecting Professionals".

Chicago Estate Planning Council-November 1985, "Rabbi Trusts--Deferred Compensation".

American Heart Association-July 1985, "Charitable Giving".

Georgia Federal Tax Conference-June 1985, "Compensation for the Closely-Held Business".

SMU Estate Planning Institute-January 1985, "Tax Planning for Professionals.

Tulane Tax Institute-November 1984, "Current Developments in Estate Planning".

American Law Institute/American Bar Association-February 1984, "Qualified Plans".

University of Notre Dame Estate Planning Institute- 1984, "Tax Planning for Professionals".

Kentucky Tax Clinic- 1984, "Non-Qualified Deferred Compensation".

Harold I. Apolinsky
Curriculum Vitae (continued)

Tennessee Federal Tax Institute-December 1983, "Incorporating a Professional Practice".

University of Alabama Federal Tax Institute-November 1983, "Tax Planning Professionals".

Michigan Tax Institute-October 1983, "Should Professionals Incorporate?".

Texas State Bar Tax Law Course-September 1983, "Should Professionals Incorporate?".

American Law Institute/American Bar Association-February 1983, "Qualified Plans".

University of Miami Estate Planning Institute- 1983, "Affiliated Service Organizations".

New York University Tax Planning Institute- 1983, "Affiliated Service Organizations".

Practicing Law Institute-July 1982, "Long Range Planning for Law Firms".

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Statement of

Raymond Arth
Phoenix Products, Inc.

Before the
House Small Business Committee

Regarding
Estate Tax Reform

On Behalf of
National Small Business United

January 31, 1995

Mr. Chairman and Members of the Committee:

My name is Raymond Arth, and I am the President of Phoenix Products, Inc., located in Avon Lake, Ohio, just outside Cleveland. I serve on the Board of Trustees of National Small Business United, and I am the 1st Vice-Chairman of the Council of Smaller Enterprises (COSE), an association of nearly 15,000 small businesses in the Cleveland area. Federal estate tax law affects my business and many others like it, so I am very pleased to be addressing this critical issue today.

National Small Business United represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. We have always worked on a bi-partisan and pro-active basis. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations (of which COSE is one) across the country.

National Small Business United is very pleased that this Committee is addressing the vital need for small business estate tax reform. We are also excited that this issue became part of the Contract with America, and that Congress at last seems inclined to once again deal with this issue.

The issues of estate planning and estate transfers have been important to me for a number of reasons. I would like to give you a little history so you will understand my perspective. Like my father and my grandfather before me, I have been involved in starting a small, family business which has managed to survive and flourish. My grandfather's company is now over 100 years old and is owned and operated by my distant cousins three and four generations removed from the company's founding. My father's business, on the other hand, is no longer in existence. In the early 1970s, he and his partner elected to sell the business to a large conglomerate which was ultimately unable to operate it profitably on an ongoing basis. One of the factors that influenced their decision to sell was concern about potential estate tax problems involving my father's partner. Unfortunately, their company and the 125 jobs it had created did not survive under its new owners.

There is one other factor that has shaped my thinking. My principle partner in starting Phoenix was my younger brother. When we started the company, he was in the middle of a long and ultimately unsuccessful battle with cancer. Even though we started the company in our early twenties, we both realized that estate planning was a major issue that needed to be addressed sooner rather than later. We devoted a substantial amount of time, money, and energy to addressing those needs, and, when the time came, we had the planning and funding in place to satisfy everyone's needs. With that personal background as a reference point, let us discuss the estate tax system.

Background

Since 1976, taxes on the yearly transfer of gifts greater than $10,000 made by a living individual and transfers made by a decedent's estate have been combined into a single, unified tax system. The tax rates on these transfers begin at 18 percent for the first $10,000 in cumulative taxable transfers and go up to 55 percent on taxable transfers of more than $3 million. In addition, a five percent surtax is applied to all taxable transfers of valued between $10,000,000 and $21,040,000.

Also in 1976, a unified credit was instituted, which effectively exempts a given amount of cumulative transfers from taxation. The 1976 law set the exempted amount at $175,625 in cumulative transfers. Fortunately, the Economic Recovery Act of 1981 addressed the issue of the unified credit once again. The 1981 law phased-in a higher effective exemption from $225,000 in 1982 to a 1987 level of $600,000, which continues to be the exemption level. It is important to realize that this exemption is cumulative over the life-time of an individual, so that five $120,000 transfers over twenty years would be treated the same as a single transfer of $600,000.

Since 1987, inflation has continued to eat away at the real value of the unified credit. Therefore, an estate transferred in 1995 would pay a higher effective tax rate than an identical estate transferred in 1987. Even if we presume that the 1987 exemption level was sufficient at the time (which is debatable at best), it is now time to reevaluate its real effect.

Estate Taxes: Real vs. Imagined

The traditional rationale for estate taxes is fairly simple: taxing unearned, windfall income at high rates does not hurt the economy and can provide needed streams of revenue to federal coffers. But when looked at more closely, we find that these presumptions do not hold up.

First, there is a widespread and preconceived--but wholly inaccurate--notion of exactly whom estate taxes are likely to affect. Many architects of our current tax code seem to believe that those who pay estate taxes are exclusively leisure-class individuals who have inherited vast amounts of wealth and property and streams of income they have not toiled a day to earn. But the fact is, we already do levy taxes on these people--for the very wealthy, estate taxes run 55-60 percent of the entire inheritance. And such individuals can shelter vast amounts of wealth in trusts that can provide a secure income stream to their heirs. So, the net effect of our estate tax system is not so much the taxation of unearned wealth, but the devastation of many small family businesses.

Suggestions that those who pay estate taxes are rich is misleading at best. Many small business owners work a life-time to build a growing and successful business, plowing profits and capital back into the business. The value of that business at the time of a transfer may seem substantial, but it often supports a very middle class family who do not have the extraordinary resources necessary to pay estate taxes. Policymakers have justified highly

confiscatory estate tax rates, since they (it is said) deprive heirs only of money they have not "earned." This type of thinking is very alarming to the thousands of family members who have labored a lifetime in their parents' businesses--in order to help build a firm which they might someday pass to their own children, only to have the government proclaim that they have not "earned" it.

I also want to remind members of the panel that every dollar of value that resides in my personal estate and every asset owned by my company has been acquired with after-tax dollars. When the company is profitable, we pay income taxes to every level of government, from the local municipality in which we live or work, to the state and federal governments. In years in which the company is not profitable, it is still taxed. We pay real estate taxes and personal property taxes on productive assets used in the business. We also pay unemployment taxes, workers' compensation taxes, and the payroll taxes that go to support Social Security and Medicare. Quite frankly, I find the notion of death annoying enough on its own; the fact that my government is going to make one last grab at my assets when I am no longer here to defend them is adding insult to injury.

Illiquidity and Small Business

In many ways, liquidity is at the heart of the estate tax debate for many family businesses. One of the biggest on-going problems for small businesses is providing sufficient cash-flow for the day-to-day operation of the business. So, when a large estate tax bill arrives, many families are forced to sell the

business to pay the taxes. Even with the $600,000 exemption, many small businesses simply do not have the liquid assets to pay their tax bill. For an estate that is only slightly above the exemption level, at a value of $1 million, federal taxes average $119,800. Certainly, a $1 million dollar family business is run by a very middle class family; how many middle class families that you know have $120,000 in cash to pay taxes?

Also implicit in estate tax proposals is the suggestion that high estate taxes do not hurt the economy, because it is a tax on "windfall income" and therefore not subject to "higher taxes hurt productivity" allegations. Windfall income? Such proponents seem to have no concept of the difference between frozen and liquid assets. A frozen asset in the form of a business would have to be sold in order to pay the taxes. Some businesses are even forced to sell piecemeal: the land, the building, the equipment, the supplies, all go to different buyers, and the business is closed. The business stops paying taxes and its employees lose their jobs. This scenario hardly represents a prescription for painless increased federal revenues.

Capital Formation

Though estate taxes are often seen as a fairness issue for small business owners, estate taxes also represent a tremendous ongoing capital drain on family businesses. For a business to face up to the many challenges posed by the estate tax and survive--intact--as a family business is a formidable chore. Effective estate planning is a drain on the resources of the business. Assets

diverted, whether to an insurance policy or another device, to pay an eventual tax is money which cannot be invested in the business to grow and create jobs. In this sense, the estate tax is a daily drain on a family business years before such a tax is ever actually owed. When a business owner has had the foresight to plan for a smooth transition, it might appear that the estate tax has had little effect on the survivability of the business. But such a business may have already been hit by the estate tax, again and again over the years, as opportunities for growth and investment were passed up, in order to channel funds for estate planning. The cost to my company is now $180,000. These funds would have been better spent on productive assets that would create jobs and strengthen the company. The system which perpetuates this situation is very short-sighted.

There is another issue of concern in our present scheme: valuing assets in a closely held business. The net book value of my company is approximately $1.3 million, but that number is not a fair indicator of the company's worth. Most of the assets of the company have value only in the context of a going concern. The customized machinery, equipment, and components are used only in our product, so the inventory and fixed assets would return only a fraction of the net book value reflected on the company's balance sheet. Perhaps we would agree that the company should be valued less. On the other hand, the Internal Revenue Service could look at the results of operations for the last year or two and claim that the business is worth four or five times its net book value. I am told that all estate tax returns are audited by the IRS and

that disputes such as this can and do occur every day. I am sure that you can appreciate the devastating impact such an audit and revaluation can have on a small, closely held business.

The Contract with America and Other Suggestions

Contained in H.R. 9, the Job Creation and Wage Enhancement Act of 1995, is a provision to raise the exemption level to $750,000 by 1997 and index it for inflation for all years after 1998. This step will certainly halt the erosion in the estate tax position of many small family businesses, and we are very supportive of taking this important step. But NSBU is eager to find more innovative and equitable ways to allow the continuation of family businesses. For the reasons outlined above, small, closely held businesses have unique estate tax problems that do not necessarily apply to all assets. So, the unique problems of small family businesses will not necessarily be solved by a general increase in the unified credit.

In addition to the provisions found in H.R. 9, there have been other proposals to treat tangible, illiquid, productive assets (such as a small business) more generously than other assets (such as cash or collectibles) for estate tax purposes. One way of doing so is to eliminate (or further reduce) the estate tax entirely on the transfer of illiquid, productive assets. Such a change would actually encourage families to invest in their businesses, quite the opposite of the current capital drain on family businesses.

There have also been proposals to eliminate the estate tax specifically for family businesses, with a carryover basis, as an elective alternative. Under this proposal, ongoing family businesses would not be forced to contend with estate taxes. But if the business were ever sold (creating liquidity), capital gains taxes would be paid on the full increase in the value of the company, since its beginning, rather than simply on the gain since the transfer.

Given both the unfairness and anti-economic growth implications of the current estate tax system, we need to find a better way. We are very hopeful that this Congress will at last produce meaningful and lasting reform for the American family business. We are very appreciative of this Committee's interest. We hope that you can relay our feelings to your colleagues on the Ways & Means Committee.

Thank you for inviting us to testify at this hearing today. We look forward to working with you on this issue as the Congress unfolds.

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STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE
HOUSE COMMITTEE SMALL BUSINESS
ON
ESTATE TAX LAW

PRESENTED BY
HARRY S. BELL
PRESIDENT OF THE SOUTH CAROLINA FARM BUREAU FEDERATION

JANUARY 31, 1995

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I am Harry Bell, President of the South Carolina Farm Bureau Federation and a member of the American Farm Bureau Federation board of directors. I operate a diversified farm in Saluda County, South Carolina. I appreciate the opportunity to comment on estate tax laws and their impact on farmers and ranchers.

The American Farm Bureau Federation is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization.

Farm Bureau applauds the efforts of this committee to hold hearings focusing on changes needed in estate tax law. Reform of our nation's estate taxes has been at the top of Farm Bureau's agenda for many years.

Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise based industry. According to the 1992 Census of Agriculture, 85.9 percent of the farms and ranches are individual or family proprietorships and 9.7 percent are partnerships. Of the 3.4 percent that are family corporations, most have 10 stockholders or less. Only 0.4 percent of the farms and ranches are corporations that are not family held. Farms and ranches that have incorporated have done so for tax and financial planning reasons, not because they are large business enterprises.

While some farms and ranches stay in the family for generations, the actual operators of farm and ranch enterprises are constantly changing. The U.S. Department of Agriculture estimates that between 1992 and 2002 about 500,000 older farmers will leave production agriculture to be replaced by about 250,000 new, young farmers. This is partly happening because the average age of farmers in 1992, according to the census, was 53.3 years.

For these retiring farmers and ranchers and the new ones who would like to take their place, now is an important time to make changes in the federal estate tax laws.

Without estate tax law changes the next generation of farmers will find it more difficult to begin farming. According to a USDA analysis of census data collected in 1988, roughly 45 percent of the young farmers who had obtained land had either purchased it from a relative (29 percent) or had received it as an inheritance or gift (15 percent). What those numbers would be without estate taxes and capital gains taxes, we will never know. What we do know is that multi-generation farms and ranches are a fact of life. How viable they will remain will be partly determined by the estate tax load they must carry.

Even though land prices declined in many areas of the country during the 1980s, in both real and nominal terms, they have recovered in recent years in most areas. As a result many farmers and ranchers are facing far higher land prices today than when they purchased the land 30 or 40 years ago. Much of this gain is due to nothing more than inflation. For example, the average price of farmland in Illinois was $234 per acre in 1965, now it is close to $1,500 per acre, over six times what it was in 1965.

In my home state of South Carolina, we have seen similar changes. In 1965 the average price of farm land and buildings was $177 per acre. Now the average is close to $950 per acre. Again that is the average. We have land, particularly irrigated land, that would have a substantially higher price per acre. All portions of the country face the same problems.

Farm Bureau has advocated for many years that the estate tax be abolished. Elimination of the estate tax should not be a major budget issue. Last year, total estate and gift tax revenue came to about $13 billion. While $13 billion is still a considerable amount of money even by today's standards, it is not such a large amount to prevent its phase-out over a number of years.

The unified credit which effectively exempts from taxes the first $600,000 of value of an estate was last increased in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit and allowance for farm use valuation are not sufficient to allow many family farm businesses to pass from one generation to the next.

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. Exact numbers are not available, but this level would likely exempt many farms and ranches from estate taxes and allow them to be passed from one generation to another, unencumbered by

federal taxes. If the exemption is not increased and a large portion of farm business assets must be sold to pay the tax, the economic viability of the operation can be destroyed and family members would be forced to abandon the farm.

The impact of an increase in the exemption to $2 million would be significant. For example, the current exemption would exclude 400 acres of average priced Illinois farmland from the estate tax. Many Illinois family farms are now more than 400 acres and at least half the land is valued at more than $1,500 per acre. This means the total value of the farming enterprise would be more than $600,000 when the value of equipment, livestock and other assets are considered. Increasing the exemption would allow many Illinois farms to be passed tax free to the next generation of farmers.

Another estate tax issue of importance to farmers and ranchers is the $750,000 ceiling allowed under Internal Revenue Code 2032A for valuing land at its agricultural productive value. Farm Bureau supports elimination of the $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use under Section 2032A.

This change is especially important in areas faced with urban growth. Land values for development in these areas are much higher than for agricultural use, rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

We also support increasing the annual gift tax exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

Keeping farms and ranches in the family has never been an easy task. The tax changes we have proposed today are a significant part of making that task just a little bit easier. We urge the committee to work for swift implementation of these measures.

Thank you for the opportunity to testify today.

STATEMENT OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

BEFORE THE

COMMITTEE ON SMALL BUSINESS

HOUSE OF REPRESENTATIVES

ON ESTATE TAX MEASURES

JANUARY 31, 1995

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SUMMARY OF STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

BEFORE THE COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ON ESTATE TAX MATTERS
January 31, 1995

Support of estate and gift tax revision. The Independent Bankers Association of America (IBAA) has consistently favored legislation that allows small and family business ownership to be passed along to future generations.

This position is expressed in a resolution duly approved by the entire association membership. IBAA is the only association that exclusively represents the interests of the nation's independent community banks.

Identifying current problems. IBAA has identified certain general problems in this field, that contribute to the attrition refected in the statistics that 30 percent of businesses are passed to a second generation and only 13 percent to a third generation. To gain detailed knowledge of how the laws may inhibit these transfers, IBAA has developed a questionnaire that is in the hands of about three dozen associations representing a spectrum of small and family-owned agricultural, commercial and financial businesses.

Recommendations. IBAA intends to work with the associations similarly concerned to develop recommendations, based upon the the information elicited by these questionnaires, that address the varying succession problems of the many different segments of the small business community.

IBAA appreciates the priority given to estate tax matters by the House Leadership. We support section 12001 of H.R. 9, the proposed increase in the filing threshold from $600,000 to $750,000 as an desirable first step. However, because of the fundamental problems involved, we also support a broad updating of estate and gift tax laws that remove current disincentives to invest and to effectively improve the prospects for ownership succession of these businesses and the economic prospects of the communities in which they are located.

STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Madame Chair, Members of the Committee: My name is Joseph S. Bracewell, Chairman of the Century National Bank of Washington, D.C., and a member of the Bank Operations Committee of the Independent Bankers Association of America (IBAA). Our association appreciates this opportunity to express banker views on a matter of direct and long-standing interest to our membership, the estate and gift tax laws. Estate tax matters are also the subject of a legislative hearing tomorrow before the House Committee on Ways and Means, and IBAA is filing a companion statement before that committee as well.

IBAA is the only national trade association that exclusively represents the interest of the nation's community banks.

IBAA SUPPORTS ESTATE TAX REFORMS

IBAA is on record in support of broad changes in the estate and gift tax in order to promote the continuity of ownership of smaller independent enterprise in all segments of the business community. This position has been expressed in resolutions approved by our entire membership. A copy of our resolution of February, 1994 is attached as an exhibit.

Accordingly, IBAA appreciates the opportunity to present its views to the committees of Congress most concerned at this time, because this subject is of special significance to community banks. IBAA commends the new House Leadership for making estate tax revision a national priority issue in 1995. It had done so by including a proposal to raise the filing threshold for federal estate taxes from $600,000 to $750,000 as section 12001 of H.R. 9, the Jobs Creation and Wage Enhancement Act, one of the series of bills introduced on January 4, 1995 to implementing the Contract With America.

IBAA commends the Chair of Small Business Committee (Ms. Meyers) on the prompt scheduling of these hearings to explore the small business implications of estate tax reform in additional detail. Our statement addresses the issues we believe are involved.

NEED FOR ESTATE AND GIFT TAX REFORM

IBAA feels it is not an exaggeration to say that the U.S. is experiencing a "quiet crisis" of inadequate savings and investment.

Federal Reserve Chairman Greenspan informed the Ways and Means Committee in a 1991 hearing on tax policy that: "the national balance sheet has been severely stretched" by large accumulations of debt in the 1980s by corporations (for mergers and buyouts), by real estate firms (for development of offices and other commercial space), and by consumers (for motor vehicles and other durables). The aftermath, Greenspan said, "is a considerable degree of financial stress . ." (Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, December 18, 1991). Chairman Greenspan's principal recommendation was as follows:

> "I and others have long argued . . . that the essential shortcoming of this economy is the lack of savings and investment. It's here that our major policy focus should rest. Investment is the key to enhanced productivity and higher living standards. . . Bolstering the supply of savings available to support productive investment must be a priority for fiscal policy (Loc. cit., pages 6-7).

From the standpoint of both national and personal saving, the situation seems to have gone from bad to worse since Chairman Greenspan's appearance. In 1992, America's net national savings rate -- the sum of savings by governments, businesses and individuals -- fell to 1.7 percent, the lowest level since World War II ("National Saving: Key to Investing in the Future," Merrill Lynch Pierce Fenner & Smith, Inc., 1993, page 1). In 1993, the figure was even lower -- 1.2 percent ("OECD IN FIGURES," Statistics on the Member Countries, Supplement to the OECD Observer No. 188, June/July 1994).

The U.S. net national savings rate is thus smaller than all but five of the 24 industrialized members of the OECD. By comparison, the 1993 savings rates for other countries with which the U.S. must compete, were: Belgium 11.5%, France 6.5%, Germany 9.8%, Japan 19.5%, Switzerland 19.3%, Turkey 10.2% and the United Kingdom 2.0% (OECD, loc. cit., pages 24-25).

For personal savings, the story is similarly dismal. In the 12 month period ending in August, 1994, the rate fell to 3.8 percent, the lowest level in U.S. history (see "Americans Run Out of Options to Boost Their Spending," by John Berry, Washington Post, October 20, 1994, page B13).

As an economist, before becoming Treasury Undersecretary for International Affairs, Lawrence H. Summers concluded that reductions in U.S. personal savings during the 1980s accounted for more than twice the decrease in national savings than did the increase in government deficits ("Savings: The Hidden National Crisis," Merrill Lynch, Inc., 1992, page 5).

Because savings and investment have lagged, productivity in the U.S. has stagnated at a rate of increase of about 1 percent a year. As a consequence, the standard of living for millions of Americans has stagnated.

A substantial amount of the investment that has taken place in the U.S. in the past decade was financed with foreign capital ("Savings: The Hidden National Crisis," Merrill Lynch etc., loc. cit., page 2).

IBAA thus hopes that the relevant committees, and the House of Representatives, will move ahead to enhance the existing tax incentives for savings in order to build up the pool of investment capital.

HOW THE ESTATE TAX DETERS INVESTMENT

As to the utilization of the pool of capital that becomes available -- and thus of direct relevance to today's hearing -- is that fact that owners of smaller family and independent businesses in this country are presently being deterred, and will, in the future, be increasingly deterred from investment by a steeply graduated federal estate tax structure.

At $100,000 of taxable estate, the federal estate tax rate is 41 percent. The rate rises to half (49 percent) at $2 million of taxable estate and 55 percent at $3 million of taxable estate. Although these numbers may seem large at first impression, our testimony will show that they are quite modest relative to the size scale needed to conduct agricultural, commercial and financial businesses in America in the 1990s.

Farm organizations tell us that in years past, in Illinois, for example, a farm could be cost effective if it was 200 to 400 acres. Now, economical farms are 1,500 to 2,000 acres, and the value per acre can be $2,000 to $2,500. A family farmer owning such a farm would face additional estate taxes in the top estate tax bracket for added investment in land, buildings and/or equipment.

A sawmill owned by three generations of a single family in the Northwest informs us that a modern sawmill, supporting about 130 jobs, now costs between $30 and $40 million dollars. About one-quarter of this amount is for occupational health, safety, and environmental expenses. The remainder is for a plant that can be internationally competitive. If a decision were made to further modernize such a mill, or to start an additional facility, all three generations of this family would face undesirable estate tax consequenses.

An example from banking, our industry, is a one location, 8-employee family bank in central Kansas, the Chairlady's part of the country. This bank has capital of $2 million and total assets of $15 million. The bank was founded after World War II by the parents-in-law of the current president, and is the sole financial institution in its small agricultural community. Both founders were tax conscious, and approximately $50,000 was spent over the years with various tax advisors, resulting in both a gifting program and estate planning trusts. Yet, after the founders died in 1988 and 1991, the survivor's estate paid the federal government $700,000 in estate taxes. The second generation owners, even now, can look forward to another bruising round with the estate tax law, which would become worse if the bank reinvests in order to grow and better service its customers.

Coping with the problems of maintaining small and independent business involves recognition by the Congress, the press and the public of the financial scale of business enterprise in this day and age. Although many citizens may perceive "small business" as a down-sized middle management executive, who invests $3,000 on a business phone system, fax and computer to start a consulting business, or a woman who does direct sales out of her family home and car, the financial scale for much of modern business is far higher than in the past and is growing. Even in service businesses, investment is significant. A single bus can cost $80,000 to $100,000. A transportation firm with a parking lot and half-dozen buses could create a bigger estate tax problem with every expansion of its fleet.

IMPORTANCE OF SMALL, INDEPENDENT BUSINESS

Small enterprise is one of the most important elements of U.S. economic life. According to the Small Business Administration (SBA), small businesses account for 53-55 percent of U.S. sales and 52-53 percent of U.S. jobs.

However, of great significance in an era of large-corporate and large-bank consolidations, is the SBA finding that, between 1976 and 1990, small businesses (500 employees or less) accounted for nearly 2/3 of the net new jobs in our economy (65 percent). Small independent businesses are often the anchors of independent communities across the country, and are therefore a tangible factor in the quality of American life. And, small business lending is the bread and butter of community banking.

THE IMPORTANCE OF SMALL BANKS TO SMALL BUSINESSES

A study of the 1993 Federal Reserve Call Report data by Robert Morris & Associates documents how strongly small banks support

small businesses. Banks with less than $100 million in assets, which would have up to 50 employees, rank, generally, as community banks. These institutions appear to make more than a quarter of all small business loans of less than $100,000 (28.17 percent, or $21.8 billion out of a total of $77.4 billion). The $21.8 billion amount of these loans by the smallest banks exceeds the total amount of such loans by any category of banks. ("Credit Availability for Small Businesses," The Journal of Commercial Lending, April, 1994, page 51).

Banks with under $100 million in assets thus concentrate on small business lending. Almost 3/4 of all their commercial and industrial loans (73.65) are of less than $100,000. Banks with assets of $100 million to $300 million make about half of their loans in amounts of less than $100,000 ($17.7 billion out of $34.2 billion, or 51.75 percent). The largest banks (over $5 billion in assets) made $17.6 billion or 6.73 percent of their loans in amounts of under $100,000

There is also evidence to suggest that megabanks, that intensely compete with other megabanks, are increasingly shying away from small business lending, where margins are slimmer, or resorting to formula-based decision on small business loans which inhibits the diversity and creativity of small business enterprise ("Is it Banking Without Boundaries or Megabanks Without Constraints? by Kenneth A. Guenther, Executive Vice President, IBAA, Washington Post, January 17, 1995).

Thus, the fortunes of small banks and small businesses are tied together. What benefits either benefits both. What harms either harms both.

THE IMPACT OF ESTATE TAXES ON BUSINESS ENTERPRISE

According to the briefing papers for the White House Conference on Small Business, about 30 percent of businesses are passed down to a second generation and only 13 percent reach a third generation. Although there are many reasons for this, federal estate and gift taxes are significant barriers to succession of ownership of smaller business.

Community bankers are thus effected directly and indirectly. Many banks are multigenerational enterprises, founded when land and structures were inexpensive. As branch locations have been added to serve growing populations, and population growth has brought residential and commercial development to the doorsteps of community banks, the value of even very small family banks can go up dramatically.

Banks are also impacted if a business customer must pay a heavy estate tax. Bank loans and the very existence of the firm may be at risk. Communities suffer because the steeply graduated estate tax rates, described above, cause many long-standing businesses to liquidate to pay the tax bill, or sell out to a large and/or absentee business to avoid such taxes. The loss of independent businesses is bad news for their home communities, because local suppliers and service providers are often phased out in favor of firms doing business with a parent company elsewhere.

One study (by the University of Wisconsin) of 39 mergers, 29 of which transferred ownership out of state, found that 70 percent of the firms shifted their accounting, legal business, and banking connections from their home community to that of the out-of-state parent. Gifts to charities by the acquired business was half as large as a comparable sample of locally owned firms ("Social and Economic Consequences of the Merger Movement in Wisconsin," John G. Udell, May, 1969).

Continued local ownership is thus key to the viability of communities -- especially smaller communities -- in which these businesses are situated.

For all of these reasons, IBAA believes that efforts of the House Leadership, and the Ways and Means, Small Business and Agriculture Committees to revisit and revise estate and gift tax rule are vital for the long-term health of the American economy.

PRIVATE SECTOR EFFORTS TO ADDRESS THESE PROBLEMS

IBAA has been trying to do its part to identify the current problems of estate and gift tax law and to develop credible solutions for these problems. For almost a year, IBAA has been actively researching this field and recruiting other associations in the agricultural, commercial and financial communities to join us in this endeavor.

We have found that there has been very little recent legislative attention to the consequences of the major estate tax changes of 1976, 1981 and 1986. One article by the Internal Revenue Service, based on 1989-91 data, finds that during the past decade, the number of estate tax filers has increased by 80 percent and the total estate of these filers increased by 94 percent. The fact that the largest block of assets in these estates tends to be stock in closely-held (small) businesses and the fact that filers with assets of more than $5 million is the fastest growing element (increasing 137 percent since 1982) reflect the increasing scale of business enterprise in this country ("Estate Tax Returns, 1989-91" Statistics of Income, IRS, Summer, 1993, page 76).

The combination of a steep estate tax rate structure and major increases in cost-efficient scale of businesses spells estate tax trouble for America's small, family and closely-held businesses.

In an effort to better identify real difficulties, and to craft responsive solutions, the IBAA has sought to assemble a group of associations, across the spectrum of American business, agriculture and finance, to call for a common effort to improve the estate and gift tax laws.

IBAA had developed a questionnaire, which is presently in the hands of more than three dozen associations. This survey is designed to elicit current data on where problems are -- and where they are not -- and recommended solutions that fit various segments of the American small business community.

IBAA and, we belive, the other associations involved in this effort, will be pleased to share the information we receive and our recommendations with the Committee and the House of Representatives as soon as possible.

INCREASING THE FILING THRESHOLD AND BEYOND

We applaud the proposal to increase the filing threshold from $600,000 to $750,000 in three stages in section 12001 of H.R. 9. Enactment of this provision would be an excellent first step, but it would not solve the fundamental problems with the current estate and gift tax structure -- the major economic problems of deterring investment and maintaining continuity of independent, job creating firms. A broader approach is needed.

We feel a combined effort to revise estate and gift taxes is worthwhile, because it would materially improve the efficiency and competitiveness of the U.S. economy all along the line.

IBAA thus has no hesitation in urging that this committee and the other committees concerned, and then the House of Representatives, move forward to pass the increase in the filing threshold, under the Contract With America, and then move on to consider and adopt borader changes to the estate and gift tax structure that address the fundamental problems that threaten U.S. businesses, their communities and the national economy to the maximum extent that is consistent with budget constraints.

IBAA will be delighted to work with the Small Business Committee, and the House, to resolve outstanding issues on small business tax matters as they work their way through the legislative process. Thank you again for this opportunity to express to the Committee our views on these important matters.

#

TAX POLICY

IBAA will work with the Administration and Congress in Washington to promote tax and related budget policies and practices that promise to accomplish the following objectives:

- reduce the deficit,
- support economic growth,
- facilitate job creation,
- encourage the establishment and growth of new enterprise,
- maintain open business and industrial structures,
- make possible reasonable succession of ownership for community-owned businesses,
- remove, and prevent creation of, barriers to capital formation, and
- maintain the stability, safety, and strength of the nation's financial system.

Deficit reduction reduces pressure on interest rates. Since modest long-term interest rates constitute the most effective stimulus to economic growth and the surest guarantee of the nation's financial stability, deficit reduction policies are to be encouraged.

IBAA will continue to advocate tax policies that support the business community as a whole–small, medium-sized, and large. Since new and small enterprise accounts for about two-thirds of our net new employment, IBAA is committed to tax policies that encourage capital formation for new and growth firms through IBAA's day-to-day Washington efforts, its contacts with associations representing small business, and special small business projects.

We believe that attention should be given to moderating estate and gift tax rates to make possible orderly succession of ownership in key community-based businesses, such as financial institutions, agriculture, manufacturing, communications, distribution and construction. We feel that the independence of such firms is the anchor of viable communities across the country.

IBAA also believes the tax laws should change course to encourage long-term savings. We strongly encourage exploration of how tax incentives could be structured, consistent with current budgetary constraints, to induce savings for such purposes as home ownership, education, and emergency health needs. The benefits of regular saving goes beyond rewarding individual and family savers, and liquidifying financial intermediaries; such savings mobilize capital for productive enterprise that increases revenues and improves the quality of American life.

In connection with consideration of a "Technical Corrections and Miscellaneous" tax bill in 1994, IBAA favors permitting the conversion of common trust funds to more than one mutual fund on a tax-free basis, so smaller banks can offer mutual fund programs comparable to larger financial institutions. IBAA also opposes any further tax burdens on activities of associations, by way of an excise tax on so-called "lobbying" expenses, or otherwise. IBAA also favors legislative relief for community banks under the mark-to-market tax accounting provision enacted in 1993, if no relief is forthcoming through administrative channels. In addition, IBAA advocates resolution of the problems created for community banks by the Revenue Ruling mandating information reporting of construction loan disbursements. ■

NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS

STATEMENT

PRESENTED

BY

PATTY DEDOMINIC

ON BEHALF OF

THE NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS

AT A HEARING

BEFORE THE HOUSE SMALL BUSINESS COMMITTE

ON

H.R. 9

"JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995"

JANUARY 31, 1995

TESTIMONY BEFORE THE U.S. HOUSE OF REPRESENTATIVES SMALL BUSINESS COMMITTEE ON ESTATE TAXES

Chairperson Meyers and Small Business Committee members, thank you for the opportunity to present testimony today on the issue of Estate Taxes. My name is Patty DeDominic. I am President and sole stockholder of PDQ Personnel Services based in Los Angeles, California, a company I founded 16 years ago with my last $2,000 in savings. Today PDQ, with an annual payroll over $10 million, is the largest L.A. based woman owned personnel service company. I am also a partner in two other small firms, one that my husband runs and one that a former employee is now managing partner of.

I serve on local, regional, and national committees addressing the issues of employment development in business, industry and government. I recently completed my second term as vice chair for the Los Angeles Private Industry Council and I was a pilot mentor in the U.S. Small Business Administration's Women's Networking Entrepreneurial Program.

I will try to focus my remarks narrowly, but want to assure you that my perspective is wide:

- as a mother of 3, a grandmother of 1
- a tax payer
- a vendor to big and small business as well as non profits and government
- as a person whose company places over 2,000 people in jobs each year
- as a community volunteer

I serve on the Boards of the Greater Los Angeles Chamber of Commerce, California Youth Employment Opportunity Program, St. Vincent's Medical Center Foundation, American Red Cross and I am a member of the Committee of 200.

I am here today to provide testimony of behalf of the National Association of Women Business Owners (NAWBO). I currently serve as the Association's President. NAWBO is headquartered in Washington D.C. and is the voice and vision for America's women business owners. NAWBO is the only national dues-paying membership organization representing the full circle of women entrepreneurs - owners of big businesses and small companies. NAWBO has 50 chapters around the country, and a growing number of Affiliate organizations and At-Large Members. Founded in 1974, NAWBO is the official U.S. member of Les Femmes Chefs d'Entreprises Mondiales (the World Association of Women Entrepreneurs). FCEM represents 33 countries around the world.

Chair Meyers, just to depart for a personal comment from our Board and many of our 50 Chapter Presidents. We are glad you are all here and are appreciative of the committee's looking out for entrepreneurs. Thank you.

My comments will be focused today on the Estate Tax provisions contained in the "Contract with America" Job Creation and Wage Enhancement Act of 1995 (H.R.9), Section 12001, which increases the unified estate and gift tax credits.

NAWBO would like to speak in favor of raising the non-taxable estate taxes from the current $600,000 exemption to $750,000 and to Small Business Valuations.

NAWBO supports increasing the amount of both the estate and gift exemptions to a rate more equitable with inflation. I'll give you 4 key points.

First, such an increase would have a tax impact, although the benefit would only be a relatively small reduction in taxes for estates over $600,000. NAWBO would also like to point out that any tax relief for small businesses is a welcome first step in reforming current tax legislation that adversely affects small businesses. A few thousand dollars in the hands of an entrepreneur with drive and vision can often be stretched tenfold.

Secondly, a $750,000 estate is becoming common even without a business. Take a person that has a residence, life insurance, profit sharing plan or a rollover IRA and some savings, and they are already fairly close to the exemption equivalent figure.

Thirdly, the real problem is that at the exemption equivalent figure of $750,000, the tax rate starts at 39% and increases to a rate greater than 55% by the time you reach $3,000,000. The tax on the additional $2,250,000 is $1,042,500 and increasing rapidly. A better solution to the problem would be to make the $600,000 a lifetime "Exemption" for Gift and Estate Tax purposes to be indexed for inflation. This would help the small businesses and individuals owning their own home, having life insurance, and a profit sharing plan or a rollover IRA and some savings, to handle the tax burden on the value of property in excess of $600,000 starting at a rate of 18% and going up to 55% at $3,600,000.

Fourth, there is a need to increase the annual Gift Tax Exclusion from the present $10,000 to at least $15,000 and thereafter to index.

It is important to keep in mind that raising the ceiling could make the difference between whether or not the family or heirs inheriting the business are able to continue the business. We're not talking about $20 million dollar businesses, but

rather a growth-oriented small business, where the value of the home and business for many small business owners is at the million dollar mark or greater already.

Real Estate alone in today's market is pushing even many of the smallest businesses into the $600,000 asset category. The $600,000 has not been indexed to inflation and has not been raised since 1987. The $750,000 is reasonable, since there has been no change for the past 7 years and if you inflated the index by 4% over 7 years you would be looking at an increase to $790,000. If you inflate in line with inflation, the $750,000 makes good sense.

Small Business Valuation is another major issue for small business. When the owner and primary decision maker dies, the business can go down hill quickly, if the prior revenues and net assets are tied to the deceased owner's success and therefore overvalued. Normally, because family members inheriting the business may not have the financing to get the company back on track after the owner's death, the burden of estate taxes, hiring new management and a high valuation for estate taxes can force a business into a fire sale. In order to get financing to run the business or to keep it going and pay estate taxes, the best argument is to value the business lower. If the business goes under, due to too high a valuation and taxes, everyone loses. Jobs and dollars to fuel the economy are lost.

Today, America faces the most extensive, far-reaching and fundamental challenges since the Industrial Revolution: the shift to a knowledge-based economy; the growing demand for training in the workplace and the need for economic growth. As all these challenges and changes occur, women are having a greater impact in the national marketplace. Over the last decade, women in the United States have gone into entrepreneurship at a rate faster than men and now own 30% of American businesses. Women business owners employ over 11 million people and this number continues to grow. Some of these businesses have been inherited, some are family businesses.

Establishing fair small business valuations and a more equitable estate tax makes good business sense. On behalf of NAWBO, I would like to again thank you for your time today and applaud your efforts to hear the voices of small business. The National Association of Women Business Owners looks forward to continuing the partnership with the Small Business Committed in future discussions on issues of importance to the small business community.

NFIB
National Federation of
Independent Business

TESTIMONY OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness:	Lee William McNutt, Jr. President, Collin Street Bakery Corsicana, TX
Subject:	Impact of the Estate Tax on Small Business
Before:	House Committee on Small Business
Date:	January 31, 1995

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TESTIMONY OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness: Lee William McNutt, Jr.

President / CEO, Collin Street Bakery

Corsicana, TX

Subject: Impact of the Estate Tax on Small Business

Before: House Committee on Small Business

Date: January 31, 1995

The National Federation of Independent Business appreciates the opportunity to submit testimony on the issue of estate taxes and their impact on small businesses. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. NFIB sets its public policy positions through regular polling of the membership.

<u>Costs of the Estate Tax</u>

The process the Committee and the Congress is now engaged in presents an historic opportunity to relieve America's small business owners from government-imposed burdens and to open the door to economic expansion and job creation in the small business sector. The federal estate tax represents perhaps the greatest burden today on our nation's most successful small businesses.

At roughly one percent of annual revenues, this tax is hardly worth the devastation it causes to family businesses and farms, entrepreneurship, and our nation's international competitiveness. The costs of such damage to small businesses and our nation's economy is unquestionably high.

<u>Small Business: America's Path to Jobs and Independence</u>

Evidence continues to suggest clearly that small business plays a rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). The nation's small business job machine has shown a capacity to produce in either good or tough times. From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created virtually <u>all</u> net new jobs in the country.

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99 percent of them are small employers. Small business as a whole employs more than half of the private sector workforce. Most small firms are not set up as C Corporations, but as proprietorships, partnerships, and subchapter S corporations.

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success. And possibly the ultimate American dream is to be able to pass that successful business on to one's children.

Evidence indicates that the vast majority of America's small closely-held businesses are family businesses. Although it is difficult to precisely define a "family business", there are clear characteristics of the family business which distinguish it from others. While other businesses are usually driven entirely by return on investment, the family business is most often driven first by other priorities -- like relationships and longevity. Family businesses are generally much smaller than publicly-traded corporations, but possess certain advantages over these larger businesses. For instance, being private, family businesses do not have to worry about quarterly earnings reports for stock analysis, and can instead focus on long-term value enhancement, even if it means losing money in the short-term in some cases. Additionally, family businesses operate without a rigid bureaucracy, consequently, they can respond quickly and intuitively to changes

in business environments. On the other hand, because of personal considerations, such as a desire to pass the business on to one's children, a family business may not always make purely rational decisions in a market-driven sense. Family businesses play a far greater role in this nation's economy than many might think -- estimates indicate that they produce roughly half of our nation's gross domestic product.

The Need for Estate Tax Reform

NFIB considers estate tax reform to be crucial to the continued survival of the small American family business. Current estate tax rates cripple a small business passed on to heirs, and often force them to liquidate a business they have worked in their whole lives. High estate taxes may provide government revenue in the short run, but the long-run losses far outweigh the gains -- a productive business is extinguished, many jobs are lost, and the American dream of growing a business and preserving it beyond one's lifetime by passing it on to heirs becomes impossible to achieve.

Because all assets are included in determining estate tax calculations, such as the decedent's home and other personal assets, many productive businesses worth far less than the current exemption level become victims of the estate tax. Because so many small businesses operate on cash flow, often with extremely small or negative profit margins, current law allowing small businesses to spread their tax liability over ten years does not provide adequate relief.

Small businesses are also particularly vulnerable to the intricacies of estate tax law. Although some owners can ensure a successful transfer to heirs by purchasing life insurance and through other methods, many cannot afford this kind of planning or do not have the time to meet with estate planners because most of their energies are directed toward keeping the business running. Unfortunately, unlike a publicly traded corporation which continues operation regardless of how shareholders plan for their death, a closely held business, unless there has been careful planning, is usually devastated by the death of an owner.

Impact on Small Business

Current estate tax rates range from 37 to 55 percent. Faced with the tremendous burden imposed by this tax upon their death, a business owner will react in several of the following ways:

1) **The business owner will not expand the business.** Especially in later years of the business owner's life, large capital expenditures for long term growth make little sense when the family will soon be forced to sell or liquidate the business. This disincentive to growth means lost opportunities, lower productivity, and lost jobs. In fact, the existence of estate taxes can deter many potential entrepreneurs from starting a business at all.

2) **The children will not participate in the business.** Knowing that taxes will prevent children from continuing operation of a family business, the business owner will often discourage their children from working in the business and encourage them to gain experience elsewhere. If the children do actively participate in the business, their experience and knowledge will often go to waste when the business is forced to be sold off. A recent survey of family businesses by Mass Mutual Life Insurance showed that only 57 percent of owners planned on keeping the business in the family, down from 65 percent a year ago; taxes were cited as one of the prime reasons for plans to sell out.

3) **The business owner will pay dearly in estate planning costs.** Even if the business owner has the foresight to plan early for their death, the expense of this planning, in insurance, legal and accounting costs, can be enough to eliminate a business' small profit margin. These extra insurance, legal and accounting costs are especially burdensome because small businesses survive on cash flow, not profit. In the NFIB Education Foundation's survey entitled Small Business *Problems and Priorities*, cash flow ranked as the third highest problem for small business, behind only the cost of health insurance and federal taxation. Coming up with the cash to pay bills and make payroll is a constant challenge in a small firm. Money left in the business -- cash flow -- is the difference between life and death for most new businesses. The costs to small business and society as a whole are high -- instead of using these funds to expand, create new jobs, and become more productive and competitive in the international marketplace, small businesses must spend the money on estate planning costs.

4) **Heirs may not be able to afford tax payments.** Despite some planning, heirs are often still imposed with some significant tax burden. Even paid out over time, taxes may be too much of a burden to survive in an internationally competitive marketplace.

Fire-Sale of the Family Business

What this means is that all too often the family business is sold-off, either before the owner's death or by the estate. Most often, a ready market does not exist for the sale of a small family run business. Consequently, the business is subject to a fire-sale -- either liquidated entirely or sold intact for a price far below its true value. Additionally, much of the value of a family business often comes from the experience and know-how of those who run it -- the family members. Their stewardship often makes the difference between a profitable, successful business enterprise, and a dying one.

All too often, the family business or farm will be bought-up by a large business such as a corporate conglomerate at a price that's a fraction of the real value of the business. While the large business may gain some of the assets of the small business, most of the real value of the former business is lost -- the entrepreneurial spirit, know-how and ingenuity, the small business' flexibility and usually most if not all of the jobs. What might have become an Apple computer instead becomes another division of a large cash register sales company.

Contrast this with what happens when a shareholder in a corporation traded on the New York Stock Exchange dies. Because there is a ready market for the stock, the estate can easily sell off enough to pay taxes. The value of that stock does not decline because of the sale. Although the stock may have new owners, the operation of the corporation continues completely unaffected by the shareholder's death.

Public Policy Reasons for the Estate Tax ?

The philosophy behind the estate tax started with early Americans who were trying to prevent the pooling of too much wealth in too few families, as had occurred in Europe. Today, however, this philosophy is fundamentally flawed. When applied to closely-held business assets, ironically, the tax produces just the opposite result -- often forcing family-owned businesses to sell-off to larger public corporations, further concentrating the wealth and power of this country and encouraging monopolistic controls of markets. This philosophy also ignores the tax's impact on communities that are dependent on these businesses, and its deleterious impact on our nation's international competitiveness against foreign countries like Japan and Germany who do not impose this kind of estate tax burden and who encourage the continuation of family-run enterprises.

<u>NFIB Estate Tax Reform Proposal</u>

NFIB strongly supports the Contract with America's Job Creation and Wage Enhancement Act proposal to raise the estate tax exemption from $600,000 to $750,000, and to index the exemption to inflation. It is a very needed first step. **We further propose that the value of closely-held business, farm and ranch assets in an estate be exempted from estate taxes altogether.**

Exempting closely-held business, farm and ranch assets from estate taxes would ensure that the business will continue and that the jobs of its employees will be protected. Moreover, this exemption would eliminate the strong disincentive that now exists for business owners to continue to develop their business and create jobs as they reach their later years in life. A recent study by the Tax Foundation found that today's estate tax rates have the same disincentive effect on entrepreneurs as a doubling of current income tax rate.

Total federal estate tax revenue represents only about $12 billion annually. Business assets represent roughly 12 percent of this $12 billion -- about $1.4 billion a year. **In other words, for $1.4 billion annually every closely-held farm, ranch, and small business in America could be exempt from the federal tax collector's axe.**

To ensure this exemption would be appropriately targeted to family businesses and farms that need it, the NFIB proposal would apply the exemption only to closely-held businesses that

constitute a major portion of the decedent's estate, such that liquid assets are not available to allow the business to remain intact. Further, heirs would have to continue operation of the business for at least ten years, or some of the estate tax would be recaptured on a pro-rata basis. Finally, to prevent abuse, the proposal would exempt from estate taxes only those assets necessary for the active operation of the business.

By restoring incentives to continue operation of closely-held businesses in the family, this proposal would fuel economic growth in the sector which produces more than half of our nation's gross domestic product. Any loss of revenue by static analysis would likely be more than compensated by a greater tax base in the small business sector.

Conclusion

Current estate tax rates impose an often overwhelming burden on our nation's small family-run businesses. The small amount of revenue this tax generates is hardly worth the long term damage impacted on these enterprises -- in the long run the tax means less economic activity, job loss, and prevention of the continuation and fulfillment of the American dream of operating one's own business and passing it on to one's children.

Exempting business assets from estate taxation would remove the single greatest government burden imposed upon small family businesses, setting national priorities where they should be: encouraging the continued operation and expansion of family businesses through generations.

STATEMENT OF CHAN NOERENBERG
WASHINGTON FARM FORESTRY ASSOCIATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
JANUARY 31, 1995

Ms. Chairwoman, my name is Chan Noerenberg. I am Vice President of the Washington Farm Forestry Association. Our association represents non-industrial tree growers throughout the State of Washington. I am also a timberland owner myself. I wish to thank you for providing me with the opportunity to testify before the Committee today concerning legislation which is vitally important to the seven million non-industrial, private landowners throughout the United States. The legislation addresses one of the most pressing issues that affects individual tree growers--the federal estate and gift tax laws.

Something has to be done about laws that force inheritors of a family farm or business to sell that enterprise in order to pay estate taxes on it. A family farm or business is not only an extremely productive component of our economy, it also provides a quality of life which millions of Americans cherish.

Forty or fifty years ago productive agricultural land could be purchased for less than $100 per acre. Today, the national average price per acre is over $750. Inflation has made estate taxes a major burden on family farms and businesses. Independent companies are being forced to merge into large corporations

because marketable stock can be acquired tax free and many estate tax problems associated with a family farm or business can be avoided.

In 1942, the estate tax applied to only one estate out of 60. Today, this number has increased to one out of 20, significantly broadening the application of the law. The sad fact is that inflation has pushed family farms and businesses that were too small to pay estate taxes into extremely high tax brackets. The result has been that heirs of these enterprises have been forced out of business because they must pay stiff Federal estate taxes.

Inflation and the increase of economic concentration through conglomerate mergers has seriously imperiled the maintenance of family farms and businesses of all kinds. Our existing tax structure has the effect of encouraging the growth of big business usually at the expense of small and independent enterprise. What we are witnessing today is a major threat to the very survival of our free and independent enterprise system.

Family owned farms and businesses are an integral and vital component of our economy and society. As a source of entrepreneurial spirit, family owned farms and small businesses must be preserved and protected. These enterprises give the family a personal sense of freedom, accomplishment, and pride in ownership. The perpetuation of the family business in America is of significant importance to the survival of free enterprise that is the foundation of our economy.

I am pleased to note that the Republican Contract With

America contains a provision which is a step in the direction of meaningful estate tax reform. This proposal would increase the unified estate and gift tax credit over a three year period to the equivalent of a $750,000 exclusion from estate and gift taxes. This would be an increase of $150,000 over the current level of $600,000. This proposal would apply to all taxpayers. As a result, the Treasury Department has stated it would lead to a $20 billion revenue loss over the next ten years. Despite this rather high price tag, we wholeheartedly support the thrust of this proposal.

There are other options for estate tax reform which we also support. One approach would significantly reduce the estate tax rates for qualified family businesses. Another would eliminate the estate tax rate entirely for qualified family business interests. We support all of these approaches and indeed have been working with a coalition of small business groups whose primary goal is to achieve significant estate tax reform for the sector of our economy which needs it most -- independently owned family enterprises. The approach the coalition has taken is to target estate tax reform to family businesses. This clearly keeps the cost of the various proposals within our current budgetary framework. I am here today to discuss one such option which we believe will provide the most significant amount of estate tax relief for family enterprises and the lowest amount of revenue loss of any of the proposals of which I am currently aware.

We propose to introduce the National Family Enteprise Preservation Act of 1995 (the "NFEP"). This measure will provide

estate tax relief to more than 98 percent of our Nation's family owned farms and businesses, allowing them to continue their many contributions to the economy, creating more jobs, advancing technology and innovation, and increasing our productivity. The proposal also recognizes the importance of children and other heirs who work in a family enterprise.

THE NFEP

1. Increase In the Unified Estate and Gift Tax Credit

The current unified credit of $192,800 would be increased to $314,600 in the case of family enterprise property. This would be an increase from $600,000 to $1 million in the amount of property that may pass free of Federal estate and gift taxes.

2. Increase In the Annual Gift Tax Exclusion

The current annual gift tax exclusion of $10,000 would be increased to $20,000 in the case of gifts to qualified family members of family enterprise property. Qualified family members are individuals who are members of the same family within the meaning of section 2032A (e)(2) of the Internal Revenue Code.

3. Special Use Valuation Changes

Currently, special use valuation cannot reduce the gross estate by more than $750,000. This amount would be increased to $1 million.

4. Family Enterprise Interest

The value of the gross estate shall be reduced by 5% for each taxable year in which a qualified family member participates in the active management of the family farm or

business following the decedent's death. The estate will be credited with the maximum deduction at the time of the decedent's death. The qualified family member must continue in the active management of the family farm or business for 10 years following the decedent's death, otherwise appropriate recapture provisions would apply. The term active management means the making of the management decisions of a business other than the daily operating decisions. In no event shall the value of the decedent's gross estate be reduced by more than the lesser of 50% or $1 million by reason of family enterprise interests.

As I stated, this proposal will totally exempt over 98 percent of our nation's family owned enterprises from the heavy burden of the current estate tax laws. Our proposal has been estimated by a private highly repected revenue estimating firm to cost approximately $5 billion over a five year period using a "static" revenue estimating method. The "dynamic" revenue estimate is considerably lower. This proposal will allow the backbone of our nation's economy, family owned enterprises, to continue to grow from generation to generation and provide jobs for millions of Americans. This proposal will provide a tremendous bang for the buck in estate tax reform.

Again, thank you for allowing me to testify before the Committee today.

TESTIMONY OF ROBERT L. SPENCE

PRESIDENT, PACIFIC LUMBER AND SHIPPING CO.
SEATTLE, WA

BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
January 31, 1995

Madame Chair, distinguished Members, Thank you for the opportunity to speak before you today regarding the issue of estate taxes, which is of utmost importance to family businesses in every community in our nation. My name is Bob Spence, I am President of Pacific Lumber and Shipping Co. in Seattle, WA. My brother and I are the third generation of our family to operate this business which was started by our grandfather in 1932. Besides our lumber export brokerage operation in Seattle, which buys lumber from sawmills all over the United States and markets these items in 53 countries world-wide, we also operate three sawmills in the communities of Morton, Randle and Packwood located near Mount Rainier in Washington State.

I have long recognized the severe disincentive to investment caused by the estate tax. As the law exists today, it threatens not only the basic fundamental principles that this country was founded on, but its resource base and the ingenuity and creativity that have in the past brought to the United States the envy and respect of every nation on this earth. I have observed over the last 35 years the slow but sure breakup of our farmland base into ever smaller tracts of land. I have watched the timberland base held by small entrepreneurs, tree farmers, and small to medium sized timber companies disappear at an alarming rate. I have watched the small to medium sized manufacturers, the entrepreneurs of America, who have set the pace for productive, creative competition in this country, slowly but with ever increasing frequency shrink under the weight of this burden.

Madame Chair, the estate tax is confiscating the heart of America. Ironically, the effects of this tax are just the opposite of its original intent of keeping the wealth of this country dispersed. Instead, the estate tax forces family owned businesses to sell to larger public corporations, concentrating the power base in this country. Is it any wonder that the productivity of this country is now being successfully challenged by other countries when you consider the burdens we are placing on the small to medium sized entrepreneur, the Family Business? Family businesses are the stimulus, the catalyst, the creators of ideas, the source of never ending energy that have in the past, and present, provided the mirror for larger organizations and corporations to gauge their performance by, and serve to help keep those organizations within reasonable cost performances. Unfortunately, with the concentration of industry and the decline of asset based family enterprises to provide the competition level to keep our larger industries finely tuned, we can no longer claim to be the leader in productivity we once were.

I can think of no better example of how this tax brings devastation to business rather than promoting it than in the timber industry of which I am a part. It was not until I experienced

the harshness of this tax first-hand that I began to realize the process that was occurring in this country. Very simply, the need to invest in a capital intensive business to stay competitive has created assets that are incurring 70 percent tax rates. This creates a scenario that sets off a remarkable set of events that, at best, amount to frantic efforts to hedge a slow death due to a cash flow drain from gift tax hedges, life insurance hedges, transfer of ownership schemes, etc., all which are very expensive because they usually involve double taxation due to income taxes--and all which transfer much needed investment dollars away from the business.

When a family involved in the timber business today incurs a death the resultant cash drain saps the business of precious cash needed for reinvestment in order to stay competitive. A new state-of-the-art sawmill today costs approximately 50 million dollars. To pay the existing tax on investments like that is impossible. It usually leaves an heir with two options: sell the business piecemeal by auctioning off the assets, or find another corporation to absorb the entity in tact, which normally means a large timber company in our business. In the case of piecemealing out the assets, this usually means dislocating a labor force which brings a great deal of hardship to small communities where sawmills exist. Because of the current escalated value of timberlands, the same characteristics prevail. I would point out here that once timberland is taken out of the productive land base and broken into smaller tracts, it will never be used for growing commercial forests again. That is why the productive private timberland base is not achieving its potential.

The same phenomenon is occurring in the farming industry. I might add that this phenomena in these two sectors of our economy, have drastic implications for the world economy, especially when you consider the rate of population growth, the reality that world-wide wood is still the number one energy source, and the role the United States has played in providing the world food supply.

Madame Chairman, I greatly appreciate Mr. Archer's recognition of the devastating impacts of the estate tax. However, because of the particularly grave consequences for family businesses, I support a more targeted estate tax relief measure, directed at the assets of family owned businesses. While I agree with and understand the desire to provide some across-the-board relief, I strongly believe that targeting estate tax relief toward the thousands of entrepreneurs in every big and small community across our nation would go far towards stimulating investment by the family held businesses who are carrying the burden of job creation in the current economy and in the foreseeable future.

In reality, the current estate tax is not a tax on the owners of these businesses as much as it is a tax on the employees and communities that these businesses are a part of because it stimulates a forced liquidation either before or after a death occurs. It forces people like us to step to the sidelines. it reconfigures our role from an involved producer and creator of real wealth that is contributing to the expansion of the tax base, to that of a passive consumer in a dormant role. That is why we are proposing than an heir or heirs who continue to operate a family business be given the opportunity to avoid the tax if they continue to operate the organization for at least 10 years, and provide a trigger for taxing

the estate if they choose to sell upon inheritance or in a short period of time after inheritance of the business.

Again, Madame Chair, I thank you for the opportunity to testify and hope to work with you as you address this terrible burden on family owned businesses.

Testimony of
Diemer True
Partner and Shareholder
True Oil and Affiliated Companies
on Behalf of the United States Business and Industrial Council

on

Estate Tax Reform and Small Business

Before the Small Business Committee
United States House of Representatives

January 31, 1995

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Testimony of
Diemer True
Partner and Shareholder
True Oil and Affiliated Companies
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on
Estate Tax Reform and Small Business

Mr. Chairman and members of the Committee, I am Diemer True, a partner and shareholder in True Oil Company and its affiliated companies in Casper, Wyoming. The True Companies is a group of family-owned businesses, most of them partnerships of S corporations, headquartered in Casper.

The companies were started by my father, H. A. "Dave" True, Jr., in 1948. The True Companies have principally been involved in oil and gas exploration and development and have expanded its operation regional pipelines, a regional trucking company, a local bank, and an agricultural business, including a cow-calf operation, two small feedlots, and a farm. The companies now employ 773 hard working Americans in the Rocky Mountain states.

In June, 1994, my father passed away. My two brothers and I purchased the bulk of the businesses from his trust and our mother. The purchase was made possible by the planning done by my parents, beginning forty years ago, principally using but-sell agreements. We, three brothers, manage the businesses.

I am here on behalf of the True Companies and the United States Business and Industrial Council. We appreciate this opportunity to offer our comments on various aspects of the federal estate tax, including proposals for change, from the perspective of a second-generation owner of a family business.

Introduction

The federal estate tax laws are a disaster for closely-held businesses. We believe the estate tax is the single greatest impediment to keeping family businesses functioning as such from one generation to another. The sad truth is that in the United States, the founder of a family business spends thirty or forty years building the business, but faces almost insurmountable barriers to passing it on to his or her children. Most founders must choose between selling the business to outsiders or leaving a life's work to almost certain dismemberment at the hands of the estate tax.

Today's world markets demand that American businesses be creative, productive and flexible. It is too much to ask that closely-held American businesses at the same time fight destruction by a confiscatory estate tax.

The small business firm, whether defined in terms of capitalization or number of employees, is the bedrock of the American free-enterprise economy. Small businesses – which are family-owned for the most part – comprise 99 percent of the private sector, with the large "Fortune 500" companies comprising the remaining 1 percent. Most of the "Fortune 500" companies are multi-national economic empires that also operate in many foreign countries. Much of their activity is outside the American economy. In terms of employees, about one-half of all American workers are employed by small businesses. Small business has been creating about two-thirds of all new American jobs. My comments are not intended to be critical of the "Fortune 500" companies, only to demonstrate that domestic economic vitality and job creation comes largely from the small business entrepreneurial spirit and that the current estate tax law is counterproductive to small closely-held businesses.

A tax that disproportionately and severely affects family businesses is therefore a threat to American competitiveness and job growth. The existing estate tax structure needlessly penalizes the most important part of the private sector – small business. I am here because the True Companies and the United States Business and Industrial Council hope the new Congress will be looking for ways to sustain the economic viability of this sector of the American economy, and that Congress should specifically look at changing the Federal estate tax.

The Problem of Complexity

One of the principal problems with the estate tax is its complexity. Like the federal income tax, the estate tax has become increasingly complex since the present scheme was adopted in 1932. This increasing complexity has touched every aspect of the tax, but perhaps none so extensively as what property is to be included in that estate for tax purposes and how that property is valued.

Property owned at death is obviously subject to the estate tax. Property need not be owned solely or outright to be included in some way in the gross estate. A large body of law, both statutory and case law, has emerged on the composition of the "gross estate." The gross estate may include, among other items:

- property transferred within three years of death;
- property transferred with retained rights of enjoyment;
- transfers that are in some way revocable;
- property over which the decedent has a general power of appointment;
- jointly-owned property; and
- life insurance policies with respect to which the decedents retain some incidents of ownership.

Valuation of the property in the gross estate is as critical to a determination of liability as a determination of what property is includable in the gross estate. Although property is generally valued at fair market value as of the date of death, the precise method of valuation is generally left to statutes, the judicial decision and administrative regulations and rulings. The lack of statutory rules and the infinite variety of property frequently make valuation the most difficult aspect of determining the estate tax.

Valuation is almost always at issue for interests in closely-held businesses, and under current law constitutes one of the greatest problems under the estate tax. Publicaly-held comparable businesses are usually very difficult, often impossible, to find. Valuing the stock or a partnership interest almost always becomes a matter for extremely expensive litigation requiring the testimony of highly-paid valuation experts -- "hired guns." The Internal Revenue Service has typically taken an aggressive position on these valuation issues, as its $600 million loss in the Estate of Newhouse case demonstrates.

The lack of a market for interests in closely-held businesses is sometimes anticipated by the use of a buy-sell agreement. Buy-sell provisions mandate the sale, or offer of sale, of a business interest to another owner of the business at a stated price or at a price determined according to a specified method. In the past, such agreements typically attempted to both create a market for interests in the business and, perhaps more importantly, provide a method for valuing the business interest for estate purposes using some easily applied formula, such as book value.

A body of law emerged from the courts and the Internal Revenue Service as to when a buy-sell agreement would be respected for purposes of valuation. A buy-sell agreement typically established valuation if the agreement applied to both lifetime and time of death transfers; mandated the sale of the business interest by the estate of a deceased business owner; was supported by bone fide business purposes; and prescribed an ascertainable sale price or methodology for determining price.

My father saw the need for book value buy-sell agreements forty years ago. Such provisions were included in the family's first partnership agreements. When my sister withdrew from the family businesses in 1984, they provided a certain means of computing the sale price of her

business interests, which the remaining family members purchased. When my father passed away last year, the buy-sell agreements again provided a method by which his interests could be valued in the sales to other family members. We hope the long history of using book value buy-sell agreements in my family's businesses will help us avoid a challenge to their validity from the Internal Revenue Service.

Most other family businesses do not have this option. The case law allowing book value buy-sell agreements was essentially repealed with the adoption in 1987 of the so-called estate freeze valuation rules in the Internal Revenue Code Section 2036(c). My family's agreements were grandfathered and therefore remain valid. Although Section 2036(c) generated a storm of controversy and was retroactively repealed by the Omnibus Reconciliation Act of 1990, a new chapter was added to the Code covering various valuation issues. The new provisions, although much more detailed and less ambiguous than Section 2036(c), have added an entire new set of complexities to the existing valuation problem. The effect of the new provisions on closely-held businesses is essentially to abandon such businesses to expert witnesses and trial lawyers to litigate the issues of fair market value in the tax courts. The high cost of litigation is an additional financial burden which compounds the difficulty of keeping small businesses intact.

As you may be aware, the Internal Revenue Code also provided for an optional method of valuing limited amount of so-called "qualified property" – generally real property used before and after death for farming purposes or in a closely-held business. Qualified property may be valued according to its actual use, not its highest and best use. While not disparaging the usefulness of this optional valuation method to certain taxpayers, the statute is highly technical and limited in scope. The case law is replete with situations of taxpayers who ran afoul of ambiguities and technicalities in the statute and who paid dearly.

As the experience with this special valuation method demonstrates, the complexities of the estate tax for closely-held businesses are not solved by adding new provisions to the Internal Revenue Code.

The Estate Tax's Confiscatory Rates

In addition to the tax's complexity, closely-held business suffers at the hands of the estate tax's rates. Those rates are both confiscatory and steeply graduated.

The rates begin at 18 percent but reach 41 percent at $1 million; 49 percent at $2 million; and the maximum rate of 55 percent at $3 million. Borrowing a concept employed by the income

tax, a 5 percent surtax is imposed that effectively phases out the graduated rates and the unified credit on larger estates.

Because the rates hit confiscatory levels at such a low threshold, the estates of many closely-held business interest owners are subject to the maximum rate.

The Unified Credit

Those not familiar with family businesses might believe that the unified credit avoids these complexities, including valuation problems, as well as the confiscatory rates, for a significant number of business owners. The so-called "unified credit" is a credit equivalent to the tax on a taxable estate of $600,000 for decedents dying after 1986. The unified credit is applied first to lifetime taxable gifts, thus first eliminating any gift tax, with any remaining credit available for transfers at death. The credit has not been adjusted since 1986.

One reason the federal estate tax is such a disaster for closely-held agricultural operations and businesses is that the unified credit amount protects only the smallest of such businesses. Most are exposed to the full effects of the tax. Increasing the credit from $600,000 to $750,000 and indexing it, as proposed in the "Job Creation and Wage Enhancement Act" (H.R. 9), will restore the credit to prior levels in real terms and is a needed first step.

The Effects of the Estate Tax on Closely-Held Businesses

The effects of the tax on the owner of closely-held business are profound. Our family has had to address those effects in order to keep our businesses functioning. From my family's perspective, let me describe how the tax has affected us.

The federal estate tax is hurting family-owned business in two ways. First, its steeply graduated and high marginal rates generate a large tax liability relative to the value of the business. Our businesses, like most family businesses, were built by reinvesting profits. We could not have done it while carrying a debt load. The vast majority of sole proprietorships or other family businesses are therefore not liquid enough to pay a significant amount of tax. Such businesses also many have difficult borrowing the funds. Although life insurance is sometimes available to fund the estate tax liability, the premiums themselves are a significant diversion of necessary cash. Furthermore, as a matter of tax policy, we do not believe that a family business should have to divert cash into passive investments and away from job-creating assets in anticipation of the estate tax.

I am aware that the Internal Revenue Code allows a deferral of payment of the portion of the estate tax attributable to the value of active business assets in a closely-held business, if the value exceeds 35 percent of the value of the estate. If an estate qualifies under this limited provision, the tax may be deferred for five years, after which it may be paid in ten annual installments. This deferral, however, may not save the business, but result only in its slow strangulation.

Thus the founder of a business who wishes that business to survive his death (and what founder doesn't), may be forced to decide between two options. One is selling all or part of the business to an outsider, instead of bringing in his own family. The other is passing the business to his own family members, gambling that the business will survive the crushing debt of the estate tax. Without our grandfathered book value buy-sell agreements, my father would have had to make this choice.

The second damaging effect of the estate tax on our busine_ses will be its cumulative effect. The estate, gift and generation-skipping tax systems are integrated to ensure that, as much as possible, the transfer of property is taxed in every generation – typically every twenty years or so. Absent a sale to a group of outsiders, the practical result of the estate tax's cumulative effect – viewed most optimistically – will be an ongoing cycle of business contractions between attempts to restore the businesses to their previous vigor. How is a business to compete in the world economy and offer stable jobs under those conditions?

Let me comment here about a proposal that surfaces occasionally that affects the federal income tax. The current estate tax allows a step-up in tax basis for assets included in an estate. That means that the tax basis is automatically increased from the decedent's tax basis to the date-of-death value. On occasion it has been proposed that the step-up rule be repealed and that a decedent's basis be carried over to his survivors. This change could add a significant income tax burden to the estate tax burden, overwhelming businesses already under siege.

What Congress Should Consider

The Federal estate tax is overwhelming in its complexity, is confiscatory, and in the long term, is counterproductive to economic growth and job creation. If family businesses are to survive as such and continue to generate more jobs and economic growth, Congress needs to take action now to stop the tax's effects on closely-held businesses. Among the options:

- Simplify the estate tax. As Congress examines various proposals for change, simplifications should be among your goals.

- Repeal restrictions on the use of buy-sell agreements and similar devices that attempt to make more certain the value of a closely-held business for both business and estate tax purposes. Establishing a market and a methodology for valuing business interests is critical for both lifetime and at-death transfers of closely-held business interests. Previous law on the validity of buy-sell agreements should be restored, both for business reasons and for relief from the estate tax. This option is not included in H.R. 9 or the proposal of the National Federation of Independent Business (NFIB).

- Eliminate the estate tax on certain business assets, including ownership interests in closely-held farms and business, in which the decedents actively participate. If ownership interests in one or more qualified family-owned business constitute 50% or more of the value of the gross estate and are conveyed to qualified heirs, then these interests should be excluded from the decedent's estate. A qualified family-owned business should include the broadest range of business entities possible, regardless of legal structure. The proposal of the NFIB includes a change along these lines.

- Significantly increase and index the amount of the unified credit so that it effectively protects an interest in the small or medium-sized family business. Indexing the credit or restoring it to its prior real level, while helpful, are insufficient to provide significant relief. An even greater increase would be more appropriate.

  The Job Creation and Wage Enhancement Act (H.R. 9) would raise the estate tax exemption from $600,000 to $750,000, and index the exemption to inflation. The U.S. Business and Industrial Council strongly supports this proposal. This is a very needed first step, but the USBIC proposes further that the value of family or closely-held business, farm and ranch assets in an estate be exempted altogether from estate taxes.

- Reduce the rates on qualified family-owned businesses that continue to be owned and actively managed by a family member. An alternative to an exemption is a special reduced estate tax rate for family business interests and business assets held by sole proprietors. A recapture provision could require that business interests be held for a period after

the death of the decedent, and that the heirs materially participate for that period, in order for business interests to continue to qualify. This option is not included in H.R. 9 or the proposal of the NFIB.

- Apply a flat estate tax rate to interests in closely-held businesses. Instead of the steeply-graduated and confiscatory rates under the current tax, a single low rate could apply to business interests and business assets. This option is not included in H.R. 9 or the proposal of the NFIB.

- Expand the applicability of the deferred payment provisions, including the four percent interest on deferred taxes. These provisions are extremely limited under current law, both in terms of qualifying and the portion of tax to which they apply. The deferred payment provisions should be made more helpful to family businesses and the four percent interest provision should be applicable to all the tax attributable to qualifying business interests. The proposal of the NFIB includes such a proposal.

Conclusion

The federal estate tax is a matter of extreme importance to family businesses in this country. In markets that are now world-wide, the pressures on businesses of competition and providing stable jobs are enormous. The added pressures on family businesses of surviving the federal estate tax are too much more to bear. With small family businesses being such a significant sector of the American economy and providing so many of the new jobs being created, this is a critical issue for the new Congress. If businesses like my family's are to continue in the hands of my children and grandchildren, my nieces and nephews, and in our community, small businesses need relief from this tax.

On behalf of the U.S. Busiiness and Industrial Council, my family and companies, I wish to thank the Committee for the opportunity to present these comments.

TAX DIVISION OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TESTIMONY OF MARK L. VORSATZ
CHAIR OF THE ESTATE AND GIFT TAX COMMITTEE

BEFORE THE COMMITTEE ON SMALL BUSINESS
OF THE U.S. HOUSE OF REPRESENTATIVES

HEARING ON
ESTATE TAX REFORM AND
THE FAMILY BUSINESS

JANUARY 31, 1995

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INTRODUCTION

Good morning, Mr. Chairman, I am Mark Vorsatz, Chair of the Estate and Gift Tax Committee of the American Institute of Certified Public Accountants (AICPA) Tax Division. Unfortunately, our Tax Executive Committee Chair, Deborah Walker, is unable to be here today, but I am privileged to replace her in representing our members. We appreciate this opportunity to offer our comments on *estate tax reform and the family business*. The AICPA is the national, professional organization of CPAs, with over 320,000 members. Many of our members are tax practitioners who work with millions of American taxpayers: individual and business. We are concerned with the impact of current estate and gift tax law upon family businesses.

OUR RECOMMENDATIONS

Family businesses are extremely important to the American economy. There are approximately ten to twelve million private businesses. These businesses account for approximately 50 percent of the U.S. gross national product and 65 percent of the wages paid. They vary in size and include small and mid-size businesses. However, there is no restriction in the size of family businesses. Some of the largest companies in the Fortune 500 are family-owned and family-controlled.

These family businesses frequently fill market niches and provide products and services that public companies do not. These businesses are critical to competitiveness, both nationally and internationally.

Despite the importance of family businesses to the nation's economy, the failure rate is alarming. About 80 percent of all start-up enterprises fail within five years. Of the remaining successful 20 percent, the typical business life expectancy is twenty-four years, which is the average working life of the founder. Less than 33 percent of successful family businesses survive into the second generation and less than 10 percent survive the transition into the third generation.

There are a number of reasons for these alarming statistics, including family dynamics, death or disability of the founder, competition, and financing. One of the major concerns contributing to financing and organizational problems for small business is the tax cost of passing the ownership of the business to succeeding generations. In addition to transfer taxes, an unreasonable income tax burden may arise from certain sales of a business on the installment basis when there are self-cancelling provisions. This additional income tax would be on the seller's final income tax return or fiduciary income tax return for his or her estate.

For estate and gift taxes the highest marginal rate is 60 percent, and for generation-skipping transfer taxes the highest applicable rate is 55 percent. The basis of taxation is the fair market value of the property being transferred. For the family business, the property being transferred is the deceased owner's interest in the business itself.

Transfer taxes may cause a tremendous financial strain on the business. The surviving owners may pay a tax of up to 60 percent or more of the fair market value of the deceased owner's interest in the business. They must use indebtedness or assets to pay the liability. Moreover, the timing cannot possibly be worse, as the payment of this tax is caused by the death of a key

owner. Therefore, there is often a change in management occurring at the same time as the tax liability arises.

To lighten the transfer tax burden on America's family businesses, the AICPA recommends a number of technical and procedural rule changes.

There are a number of valuation concerns that arise when family businesses are transferred. Businesses with a value of $5 million or less should be exempt from the Chapter 14 special valuation rules. These rules are far too complicated for businesses of this size. To alleviate problems in applying these rules, we recommend a safe harbor rate of return for valuing retained interests in a business when the older generation transfers equity to a younger generation. In addition, the rule that buy/sell agreements must be comparable to arms-length agreements is inappropriate for buy/sell agreements in the closely-held business context.

Administratively, we support a procedure whereby taxpayers can make a ruling request concerning the value of assets to be transferred, thereby eliminating future disagreements with the Internal Revenue Service about value. Similarly, taxpayers should be able to make a request for the assessment of gift taxes so that the statute of limitations will lapse after a three-year period.

Certain judicial decisions result in our recommendation that Congress should overturn current case law which allows the Internal Revenue Service to retroactively adjust gift tax values, even after the statute of limitations has expired. We also suggest eliminating gain recognition when the installment notes are cancelled at death and requiring the purchaser to take a basis equal to payments actually made.

As we will testify tomorrow before the House Ways and Means Committee on the tax provisions in the "Contract With America," we support an increase in the unified credit to $750,000 and indexing this amount in future years. Finally, to lessen liquidity problems for closely-held businesses at the death of the owner, we recommend establishing a lower interest rate for all deferred estate tax payments.

Again, we believe family businesses have many special problems and should be given special consideration.

<u>Exemption from Special Rules for Small Businesses</u>

Background: Prior to the enactment of the Chapter 14 special valuation rules, estate planning in the family business context involved "estate freeze" techniques, intended to "freeze" the value of the older generation's interest at its current level and permit all future appreciation in value to pass to the younger generation outside the transfer tax system. To control these transactions, Congress enacted provisions focusing primarily on gift tax implications. Chapter 14 of the Internal Revenue Code sets forth several criteria for determining whether a taxable gift has been made and for establishing the gift tax value at the time the property is transferred. I.R.C. § 2703 also establishes the estate tax value of property transferred at death.

Concern: Because of the complexity and detail of these rules, the transfer taxation of some transactions continues to be uncertain and the statute appears to create some unintended results. Small businesses have an especially hard time dealing with these rules.

Recommendation: The AICPA recommends that transfers of interests in family businesses whose value is less than $5 million would not be subject to the Chapter 14 rules. This exemption from Chapter 14 would not be an exemption from the normal gift, estate and generation-skipping tax rules.

Establishment of a Safe Harbor Rate of Return to be Used in Valuing Certain Interests in Family Businesses

Background: Internal Revenue Code (I.R.C.) section 2701 provides special valuation rules applicable to transfers of certain interests in corporations or partnerships. The statute applies if the older generation retains an applicable retained interest and transfers an equity interest in a corporation or partnership to his or her spouse or the younger generation. The retained interest is typically preferred stock or a preferred partnership interest and the transferred equity interest is typically common stock or a limited partnership interest. This provision values the transferred equity interest by subtracting the applicable retained interest value from the overall value of the entity. In determining this value, certain rights are ignored and other rights are valued under existing valuation principles. Treas. Reg. § 25.2701-1(a)(2)(1992). To support the applicable retained interest value, a cumulative rate of return must bear a fixed relationship to a specified market interest rate. I.R.C. § 2701(c)(3)(B).

Concern: There is considerable uncertainty with many practitioners and appraisers about the appropriate rate of return for the applicable retained interest value. If the rate of return is too low, the gift tax value of—and the taxes paid on—the transferred interest increase.

Recommendation: The AICPA recommends that there be a safe harbor rate of return that would exist for all transactions subject to the special valuation rules. This rate may be a percentage of the applicable federal rate, the prime rate or other published interest rates.

Elimination of the Comparability Requirement in Establishing an Effective Buy/Sell Agreement

Background: The use of value-fixing agreements is very important in providing certainty and objectivity in business dealings for business associates. However, the IRS contends that such agreements encourage abuse by allowing related business associates to agree to artificial restrictions and conditions which lower the business value. I.R.C. § 2703, intended to curtail the perceived abuses, requires that restrictions and conditions in the related party buy/sell agreement be comparable to those in an arms-length agreement.

To have an effective buy/sell agreement under the current law, there are three requirements: (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to family members for less than adequate and full consideration; and (3) the terms of agreement be comparable to similar arrangements that people would enter into in an arm's length transaction. I.R.C. § 2703(b)(3).

Concern: The comparability requirement creates uncertainty as to the effectiveness of the buy/sell agreement in determining value for transfer tax purposes. As a result, many advisors are not using buy/sell agreements for fear of not meeting the comparability standard. An agreement may be legally effective in determining the sales proceeds that a taxpayer or estate receives, but the IRS may succeed in asserting transfer taxes based on a substantially higher value. The higher value results in a higher tax liability which would distort the dispositive plan of the gift or bequest.

Recommendation: The AICPA recommends repeal of the comparability requirement so that families can effectively use buy/sell agreements in making transfers of interest in closely-held businesses.

Administrative Changes to Provide Certainty for Valuations

Background: Transfer taxes are based on the fair market value of assets transferred. Family businesses present a number of special valuation concerns. In addition to being difficult to value, there is no existing procedure for assuring that the valuation used by the taxpayer for determining tax liability will be agreed to by the Internal Revenue Service. There is currently no administrative procedure for determining whether a valuation is accepted by the Internal Revenue Service.

Concern: Uncertainty arising with the valuation of family businesses increases the business risk of operating these businesses.

Recommendation: The AICPA recommends that there be a procedure similar to a private ruling request for valuations subject to the Chapter 14 rules to provide certainty for the taxpayer and the government. The taxpayer could be charged a user fee for this request. The government would have an opportunity to review all pertinent appraisals and other documentation before making its determination as to the appropriateness of the value.

The AICPA recommends that taxpayers be able to make a request for gift tax assessment even though gift tax is not due with the return. The IRS would have three years to examine the reported value of a closely-held business. After that time period, the statute of limitations would expire.

Provision for Expiration of Gift Tax Statute of Limitations

Background: Courts have held that the lapsing of the gift tax statute of limitations does not prevent the IRS from increasing adjusted taxable gifts in the estate tax calculation. Evanson v. United States, 30 F.3d 960 (8th Cir. 1994), Levin v. Commissioner, 986 F.2d 91 (4th Cir. 1992), Smith v. Commissioner, 94 TC 872 (1990), acq. 1990-2 CB 1. However, a District Court reached a contrary result in Boatman's First National Bank of Kansas City. 705 F.Supp 1407 (DC Mo. 1988). The regulations provide that the IRS may adjust prior gifts in determining the gift tax due and the unified credit available in a later gift tax return unless there is an actual payment of gift tax. Treas. Reg. § 25.2504-2 (1983).

Concern: The ability to make retroactive adjustments upon examination of a gift or estate tax return creates unnecessary uncertainty for taxpayers. This uncertainty discourages intrafamily transactions which are necessary for ownership succession.

Recommendation: The AICPA recommends that Congress should enact legislation to modify the judicial interpretation that allows retroactive adjustment of the current taxable gift so that the gift tax statute of limitations will expire even though there is not a gift tax payment and the adjusted taxable gift cannot be revalued on the estate tax return.

Treatment of Self-Canceling Installment Notes from an Income Tax Standpoint

Background: There is no statute that deals specifically with self-canceling installment notes. In Frane v. Commissioner, 98 TC 341 (1992), the Tax Court held that installment notes which cancelled at death were included in income on the decedent's final return. However, in a well-written dissent, five judges concluded that there was no disposition of the notes that would require any gain to be reported. 98 TC 341, 357 (1992). The Eighth Circuit Court of Appeals recently reversed this decision and treated the cancellation as a disposition requiring income recognition in the gross income of the estate. 998 F.2d 567 (8th Cir. 1993). This treats two transactions that are economically very similar, self-cancelling installment notes and private annuities, differently.

Concern: Because payments are not made on the installment note after death, there is often not sufficient liquidity to satisfy the decedent's related income tax liability.

Recommendation: The AICPA recommends that no income be recognized as a result of the death of the seller/lender and that the purchasers/borrowers would receive a basis equal to the payments that they have actually made. This does not create the possibility for abuse because there will be no increase in basis without recognition of gain. The purchasers/borrowers would realize income when they ultimately sell the stock. With this change, the need for cash to pay an income tax liability for the decedent would be lessened.

Increasing and Indexing the Unified Credit

Background: In 1981, the Economic Recovery Tax Act increased the unified credit so that a certain amount of an individual's estate could be transferred without incurring gift or estate taxes. The law phased in the credit over a six-year period to its present exemption equivalent amount of $600,000.

Concern: In 1987, this amount was fully phased in and seven years of inflation have eroded this figure. The unified credit will now only protect $475,000 of property as measured in 1987 dollars. Surprisingly, this erosion has occurred in a period of relatively low inflation. This type of erosion particularly hurts the middle class and many family business owners. As a result, there are many individuals who find themselves subject to an estate tax that was meant to apply to the wealthy.

Recommendation: The AICPA recommends that Congress increase the unified credit to bring it in line with the intentions as set forth in 1981--to establish an exemption equivalent that would

allow middle class Americans to pass property to their children without worrying about estate taxes. If the unified credit were adjusted for inflation since 1987, the exemption equivalent would be at least $750,000. Furthermore, after the unified credit has been increased to nullify the effect of seven years of inflation, the AICPA recommends that Congress index the unified credit to prevent the middle class from being subject to additional estate tax due only to inflation. Indexing will reduce the number of tax returns that individuals would be required to file and will allow IRS personnel to focus on the larger transfers of wealth.

Reduction of the Interest Rate for Deferred Estate Tax Payments Pertaining to Closely-held Businesses

Background: There are currently two provisions in the statute available to the estates of deceased owners of closely-held businesses. I.R.C. § 6161 allows the IRS to extend the time for payment of estate tax for up to 12 months after a payment is due for reasonable cause. I.R.C. § 6166 allows for a five-year deferral of tax with installments to be paid over a ten-year period at the end of the five-year deferral for certain interests in closely-held businesses. The interest rate charged for these deferred estate taxes is equal to the underpayment rate applicable to unpaid income taxes. These provisions are important for closely-held businesses that cannot easily access capital markets for liquidity to satisfy estate tax liabilities. Under certain circumstances, the statute provides for a four percent interest rate on up to $153,000 of deferred tax. I.R.C. § 6601(j).

Concern: The underpayment rate for income taxes is intentionally high to create a disincentive for taxpayers who fail to pay their taxes on a timely basis. This disincentive and the resultant high rate is not appropriate for estate taxes deferred because of an inability to pay. As mentioned previously, closely-held businesses face great difficulties in paying 55 to 60 percent of their fair market value as estate tax. These two deferral provisions recognize this inability to pay, and lack of access to the capital markets, but provide for too high an interest rate. The relatively high interest rate currently charged exacerbates the liquidity problem that these closely-held businesses face.

Recommendation: The AICPA recommends that the interest rate be reduced on all deferred estate tax payments under I.R.C. §§ 6161 and 6166.

Once again, we appreciate the opportunity to present our views here today and we are willing to assist you in any way.

NATIONAL CATTLEMEN'S ASSOCIATION
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Comments

on behalf of the

NATIONAL CATTLEMEN'S ASSOCIATION

in regard to

Estate Tax Reforms

submitted to

United States House of Representatives
Committee on Small Business

submitted by

Jim Turner
Vice-Chairman, Tax and Credit Committee
Chairman, Estate and Gift Tax Subcommittee
National Cattlemen's Association

January 31, 1995

The National Cattlemen's Association is the national spokesman for all segments of the beef cattle industry -- including cattle breeders, producers, and feeders. The NCA represents approximately 230,000 cattlemen. Membership includes individual members as well as 46 affiliated state cattle associations and 29 national breed association.

Madam Chairman, Mr. LaFalce, members of the House Small Business Committee, thank you for your concern about the estate tax impact on farmers, ranchers, and other family-owned businesses. The National Cattlemen's Association appreciates the opportunity to submit comments.

I am Vice-Chairman of the Tax and Credit Committee of the National Cattlemen's Association and Chairman of the Estate and Gift Tax Subcommittee. I am a cattlemen and a practicing attorney, concentrating on real estate and tax matters. While my tax background primarily involves real estate, corporate and partnership matters, I have done some estate tax work as well, particularly for families in agriculture. Our family has owned a cattle and citrus enterprise in Sarasota County, Florida, for the past 50 years or so. My father, Latimer H. Turner, who is now deceased, was a past chairman on NCA's Tax and Credit Committee and a past-President of the Florida Cattlemen's Association.

One of the National Cattlemen's Association's top priorities for the coming year is estate tax reform. Indeed, estate taxes have been a priority issue for the NCA for many years. Currently, 80% of beef cattle operations have remained in one family for 25 years or more, with 42% over 50 years, and 12% more than 100 years. Surveys indicate the average age of cattlemen is now 55 years. Those statistics suggest that there are currently a lot of senior family members owning ranches whose families will soon face the burden of federal estate taxation. The number of cattle operations has declined 20% from 1981 to 1993, to the lowest level of the century. The impending burden of federal estate taxes is likely to only accelerate that trend.

We feel the burden of estate taxes has contributed to families selling their family farming and ranching enterprises, resulting in the concentration of these enterprises in fewer and fewer hands. This concentration is contributing to the deterioration of rural America. Therefore, the NCA supports a number of proposals for modification of the federal estate and gift tax laws which would benefit farmers, ranchers, and other family business owners.

We urge you to take this historic opportunity provided by recent elections and fundamentally change the estate tax laws as they apply to family businesses.

The NCA supports the provisions of the Jobs Creation and Wage Enhancement Act of 1995 (H.R. 9) which contain an increase of the Unified Estate and Gift Tax Credit to $750,000 and index the amount thereafter. Inflation has eroded the benefit of the current $600,000 Unified Credit Equivalent limit just as the benefit limit on Section 2032A has been eroded over the last several years, as discussed above.

The NCA encourages a re-examination of the entire estate and gift tax structure, and its impact on family owned businesses. There is a proposal being discussed by a number of business groups, including our organization, designed to reduce or eliminate the estate tax burden on farmers, ranchers, and other family-owned businesses. This proposal, which we hope will be introduced soon, is similar to H.R. 5032, the Family Preservation Act, sponsored by Congressmen Brewster, McCreary and others in the 103rd Congress,

would reduce or eliminate the estate tax rate when at least half the value of the estate is a family owned business. This is a strong incentive for successful entrepreneurs, including cattlemen, to keep working and creating jobs, rather than selling out to others. A June 2, 1994 study of the Tax Foundation concluded that estate tax laws can have roughly the same disincentive effects on entrepreneurial activity as a doubling of income tax rates. Such a burden cannot stand.

If the estates of farmers and ranchers are required to sell their agricultural holdings to pay estate taxes, particularly in our area of southwest Florida, the land will most likely be sold to corporate or foreign agricultural interests or to development interests and the development process will be accelerated. The members of the NCA know their land, they love their land and they have been good stewards. Most of the ranchers in our area want to stay in agriculture. The environment would benefit from leaving these lands as open space and in the hands of the current owners. However, the burden of estate taxes as currently imposed may take this decision away from them.

As mentioned earlier, several of the business groups that the NCA works with have listed estate tax reform as a priority issue, including the Independent Bankers Association of America, the American Farm Bureau Federation, National Small Business United, Small Business Legislative Counsel, the National Federation of Independent Businesses, and many more. The White House Conference on Small Business is currently holding conferences around the country in preparation for the national conference on June 11 through 15, 1995. We will use this forum to discuss and promote estate tax reform for family-owned businesses.

Cattlemen were actively involved in the initial discussions of Section 2032A, *Special Use Valuation*, which allows farmers and ranchers to value their property based on productive values rather than market value for estate tax purposes. We strongly support this very useful estate tax tool and request that the following changes be considered in the 104th Congress.

The maximum amount an estate can be reduced by electing Special Use Valuation pursuant to Section 2032A has been fixed for the past several years at $750,000 (for decedents dying on or after January 1, 1983). Therefore, the benefit of this reduction in estate tax valuation available to farmers and ranchers has been eroded. Congressmen Bill Thomas from California has introduced H.R. 520 to double the 2032A valuation limit from $750,000 to $1,500,000. We also applaud Congressman Hoyer for his introduction of H. R. 532, which indexes the unified credit. The NCA supports both of these bills.

Section 2032A, in addition to Internal Revenue Code Section 6166 (*Installment Payment of Estate Taxes*) both require recapture of the benefits provided by those sections if the farmland is cash-leased after death, even to a relative. We believe that a cash lease to a relative satisfies the public policy goal of keeping farmland "within the family" after death. Therefore, Sections 2032A and 6166 should both be amended to allow farmland to be cash-

leased to a relative after death without requiring a recapture of the benefits under 2032A and 6166.

On a related matter, Section 6166 (*Installment Payment of Estate Taxes*) is often used in tandem with the special use valuations provisions of Section 2032A. Section 2032A allows property to be considered qualified if it is used and held for use as a farm or other closely-held business by the decedent or a member of his family such that a cash lease by the decedent to his family prior to death would qualify. However, for the purposes of Section 6166, farmland leased on a cash basis prior to death, even to a relative or to an entity owned by the same individuals as own the land, will not qualify as a closely-held business under Section 6166. Therefore, Section 6166 should be amended to conform with Section 2032A.

Furthermore, the Treasury Regulations under 2032A currently require compliance with a lot of detailed filing procedures for a farmer or rancher to be entitled to the benefits of Section 2032A. The regulations allow an estate the opportunity to cure any procedural defects only if the original filing substantially complies with the regulations. There has been a lot of litigation over the question of the circumstances under which an executor has "substantially complied." We believe an executor should be allowed to supply any missing information within a reasonable period of time (not to exceed 90 days) after notification by the I.R.S. of a procedural deficiency without regard to the question whether the original filing "substantially complied" with the regulations. The current interpretation of substantial compliance has resulted in hardship and, we feel, unintended results.

Congress needs to retroactively invalidate the effective regulations Section 20.2032A-8(a)(2), which was deemed to be invalid by the court in Estate of Miller v. U.S.A. (U.S. Dist. Ct. for Central Dist. Illinois, March 9, 1988) 88-USTC ¶13,757, thereby making clear that Section 2032A of the Internal Revenue Code does not require a 2032A election as to 25 percent of the estate, but merely requires that 25 percent of the estate qualify for the election. I am enclosing a memorandum to the NCA's Tax and Credit Committee from me dated November 22, 1991 which further explains this issue.

Another problem with the regulations under 2032A is the requirement that every heir holding an interest in an estate, no matter how small, how contingent, or how remote, must sign the recapture agreement pursuant to the benefits of Section 2032A if the farmland is disposed of within ten years of the date of death of the decedent. There ought to be some provision pursuant to which the holders of small contingent interests, such as that actuarially valued as equal to or less than two percent of the total, do not have to sign the recapture agreement. The federal tax lien created by the Code on the subject farmland would be sufficient to enforce the Treasury's recapture rights under 2032A if the property was sold within the ten-year period.

Once again, I appreciate the opportunity to submit comments to this Committee. We want to work with you this year to achieve significant estate tax reform.

NATIONAL
GROCERS
ASSOCIATION

January 27, 1995

The Honorable Jan Meyers
Chairwoman House Small Business Committee
U. S. House of Representatives
2338 Rayburn House Office Building
Washington, DC 20515-1603

Dear Representative Meyers:

On behalf of the board of directors and members of the National Grocers Association (N.G.A.), I would like to commend you for your leadership in initiating hearings before the House Small Business Committee regarding the effects of federal estate taxes on small businesses. The N.G.A. strongly supports reducing the financial burdens imposed by existing gift and estate tax laws. Federal tax policy should be designed to protect and encourage the growth of family-owned businesses, rather than threaten their very existence. On behalf of the members of N.G.A., I respectfully request that the views of our membership expressed within this letter be entered into the record for the January 31 hearing.

The National Grocers Association is the national trade association representing retail and wholesale grocers who comprise the independent sector of the food distribution industry. Operating more than 50,000 stores, this industry segment accounts for nearly one-half of all food sales in the United States and employs more than 2 million people. Because N.G.A. represents independent grocers, a large percentage of our membership is comprised of family-owned businesses. Many of them have been passed down through several generations and currently have two or three generations represented in the business management. In fact, N.G.A. conducts quarterly Entrepreneurial Institute sessions which are specifically focused on perpetuating family-owned businesses.

Current federal estate tax laws have a maximum rate of 55 percent, substantially higher than the maximum income tax rate and substantially higher than estate taxes in other industrialized countries. In addition, the unified estate and gift tax credit was established in 1981 to exempt estates valued at $600,000 or less. There has been no indexing for inflation since that time. This amount includes the market value of all assets. Consequently, the confiscatory nature of the estate tax drains capital from a business, and jeopardizes the successful transfer of property from one generation to the next. Upon a

death of the major family owner, too often the family simply cannot borrow enough to pay off the government and is forced to sell the business, frequently to large corporations who have no vested interest in the community or the welfare of the employees. If a buyer is not available, the business may be forced into bankruptcy or dissolution by the death of the majority owner.

Estate taxes threaten not only the continued existence of family-owned businesses, but they pose a deterrent to economic growth in this country. According to a study by the Center for the Study of Taxation, Costa Mesa, California, approximately 90 percent of the nation's businesses are family-owned businesses which generate 40 to 60 percent of the gross domestic product. They employ over 40 million people, more than one-half of the nation's workforce. Family-owned businesses continued to provide jobs during our recent recession at a time when large corporations were downsizing payrolls. Yet it is estimated that approximately 3 million family businesses will be forced to transfer ownership in the next 10 to 20 years due to the estate tax burdens.

Present estate tax laws unfairly penalize business owners and their employees who have invested capital and effort into developing growing enterprises. They discourage entrepreneurs from investment, expansion and creating jobs. Federal tax laws should provide incentives that assure family owned businesses can continue to grow and develop, strengthening the nation's economy.

Legislation has been introduced in the 104th Congress, H.R. 9, the Job Creation and Wage Enhancement Act, that would increase the unified estate and gift tax credits from $600,000 to $750,000 and index it for inflation. In addition, Rep. Livingston has introduced H.R. 81 to increase the unified credit to $1.2 million. N.G.A. supports these bills but this is not sufficient to achieve tax equity for the family-owned business. In the 103rd Congress, N.G.A. supported legislation introduced by Rep. Bill Brewster. It would have reduced the estate tax rate to 20 percent if the heirs continue to be active in the business and provided for "recapture" of estate tax savings if the business is sold within 10 years. It provided an alternative valuation date of 40 months after the death of the decendent in order to resolve valuation disputes where the business is closely tied to the skills of the primary owner. The legislation indexed the unified credit for inflation. This legislation provides a number of examples of the effective incentives Congress should pass to encourage family businesses to continue to expand and to create jobs.

N.G.A. thanks you for your consideration of the views of the nation's independent retail grocers and the wholesalers who serve them. N.G.A. looks forward to working with members of the Small Business Committee and Congress as tax legislation is drafted to provide estate tax relief. We are currently in the process of surveying our members on the effects of estate taxes on their business operations. We look forward to providing you with the results of this survey in the coming months. The N.G.A. public affairs staff would welcome the opportunity to provide you with specific information regarding the impact of estate and gift taxes on privately-owned and operated retail and wholesale grocery companies.

Sincerely,

Thomas K. Zaucha

Thomas K. Zaucha
President and CEO

STATEMENT OF THE

NATIONAL ASSOCIATION OF HOME BUILDERS

before the

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

on

CERTAIN TAX PROVISIONS

of the

CONTRACT WITH AMERICA

JANUARY 31, 1995

TESTIMONY OF THE
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
HOUSE COMMITTEE ON SMALL BUSINESS
JANUARY 31, 1995

Chairman Meyers and members of the committee, the National Association of Home Builders (NAHB) and its 180,000 members, congratulate you for holding these hearings and appreciates being given the opportunity to provide this statement for the record. NAHB has long been supportive of many of the proposals contained in the Contract with America.

OVERVIEW

The Contract with America's provisions contain a number of proposals and ideas which NAHB has supported and advocated over the past few years. Specifically, the tax and penalty-free use of IRA funds for first-time home purchase, reinstatement of a capital gains rate differential, clarification of the home office deduction rules and other small business incentives have been a part of the established policy of NAHB for quite some time. This statement will address those specific proposals and offer our suggestions for improvement, where appropriate. It will also address the self-employed health insurance deduction and independent contractor issues, which are also the subjects of this series of hearings.

CAPITAL GAINS

The Contract would provide three capital gains incentives: (1) a 50 percent capital gains reduction, (2) indexation of the basis of capital assets to eliminate inflationary gains, and (3) a capital loss deduction for homeowners.

NAHB supports reinstatement of a capital gains rate differential for real estate and other assets and their indexation for inflation. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction. For example, taxation of capital gains at 50% of ordinary income rates would eventually reduce all rents by 5%. This represents a tax cut for the middle class and those struggling to become middle class. Yet another example of why a capital gains tax break is not for the wealthy.

NAHB believes that taxation of assets held for one year or more at a lower rate than ordinary income encourages investment and savings. However, tax[illegible]ion of realized gains on long-held assets at ordinary income rates (i.e. on sale or trans[illegible] reduces the economic incentives to invest in the most efficient, highest return opportunities. Removal of the retardant effect of current law taxation would allow taxpayers to place their capital in the most promising sectors of the economy. More efficient capital flows would create jobs and stimulate the economy.

A capital gains tax cut would not benefit only higher income taxpayers. One-half of the 1991 tax returns claiming a capital gain or loss reported incomes below $60,000. Furthermore, encouraging investment through reduced taxes on the gains from that investment would create jobs and economic activity at all levels of income.

With respect to real estate, a capital gains preference would increase investors and owners incentives to purchase, rehabilitate and operate rental housing. Part of the total return to investors who own rental housing is property appreciation. The greater the owners after-tax income from the appreciation portion of their return, the less income required from rents to achieve the same earnings. Reducing capital gains tax rates will reduce residential rents. Since much of the appreciation in housing is due to price inflation, adjusting the gains for inflation will reduce rents even more.

We must insist however, that any capital gains incentive include real estate. Just as real estate served as the engine to lead the economic recovery, so it must be included in any capital gains reduction in order to maximize the dynamic economic impact of the proposal. Indeed, inclusion of real estate effectively rebuts any argument that a capital gains tax cut would favor only wealthy taxpayers.

The capital loss deduction provision would allow taxpayers to get out of homes that have fallen in value. For taxpayers who may be hesitant to move to another dwelling, the provision would help to soften the financial repercussions of taking the loss on their current home. NAHB supports allowance of a capital loss deduction for sale or disposition of a principal residence.

HOME OFFICE DEDUCTION

The United States Supreme Court's Soliman decision effectively eliminated the home office deduction for the real estate construction industry. NAHB fully supports the proposal to clarify the standards for claiming a tax deduction for maintaining an office in the home.

Home building is dominated by small firms, many of which use home offices as their primary administrative location for doing business. Eighty percent of NAHB's builder-members construct fewer than 25 homes a year and most of these firms do not maintain a separate office. Many operate out of their homes, making necessary contacts with subcontractors and customers, and where, very often other family members assist in the administrative and clerical duties of the business.

The Contract proposal will help reduce housing costs by reducing builder/remodeler's costs. Because of the highly competitive nature of the construction business and the number firms available to perform services, the reinstatement of the home office deduction will translate into lower house prices. For an average builder who constructs 10 homes a year, and uses his home as the center of operation, the savings could be several hundred dollars per home.

INCREASED DEPRECIATION DEDUCTIONS AND NEUTRAL COST RECOVERY

NAHB supports adjusting real estate depreciation to account for inflation.

The Contract would allow taxpayers to adjust real estate depreciation amounts to reflect inflation. The inflation adjustment would put depreciable assets on an equal footing with expensed items. Currently, a business that purchases a piece of depreciable machinery can deduct a certain percentage of that machine each year, based on the principle that each year some of the machine is "used up". However, as inflation further erodes the value of the capital asset, the residual value of the asset is lessened. Expensed items, on the other hand, because they are purchased in the year of deduction, already reflect inflation.

Inclusion of real estate in the neutral cost recovery provision is particularly important in that the straight-line depreciation periods are long, and more directly impacted by inflation. Further, real estate can not be "expensed" as with business equipment.

INCREASE IN UNIFIED ESTATE AND GIFT TAX CREDITS

As pointed out above, home building is dominated by small firms which very often are family owned and operated. The current estate and gift tax laws operate to destroy family-owned businesses by imposing a tax upon the inter-generational transfer of the business. Moreover, the economic impact of the tax increases from year to year because of inflation. NAHB fully supports increasing the amount of the unified credit to $750,000 and indexing that amount for inflation.

INDEPENDENT CONTRACTOR CLASSIFICATION

NAHB believes that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

INDEPENDENT CONTRACTOR CLASSIFICATION

NAHB believes that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

We believe that the current law pertaining to worker classification recognizes the unique characteristics of the home building business and allows the flexibility necessary for building industry workers to function in a changing economy. Moreover, the current rules under Section 530 of the Revenue Act of 1978 provide equitable relief for taxpayers who become involved in disputes with respect to worker reclassification.

INDUSTRY PROFILE

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades, and because job sites necessarily change as the homes are built, the relationship between the homebuilder and the person who performs the different trades varies widely. Another complicating factor, principally from the standpoint of the approach the Internal Revenue Service has made to many homebuilders, is the fact that a homebuilder routinely does "sub-out"- that is, hire an independent contractor to perform services which may, in the minds of the IRS, constitute performance of "common labor". In those instances, the IRS often alleges that the person is an employee rather than an independent contractor. The construction of single family homes is basically the coordination of the work of as many as 18 different subcontractors.

Since the volume of work in the homebuilding industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. In today's market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships. During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

A builders' organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 8 percent of the medium- and large-volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships.

LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform all the operations it takes to develop land and build and market homes. According to NAHB's 1987 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work and sell through real estate agents.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from

financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 55 percent by 1987. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 14 percent. Large-volume builders tend to subcontract a larger share of the construction cost. Builders in the South use subcontractors for a larger share of construction than builders in the Northeast, Midwest, and West. NAHB's 1987 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. An NAHB survey of builders in 1987 showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1987 Census of Construction indicated that residential builders subcontracted $41 billion, or 40 percent of the value of their construction receipts. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 15 different subcontractor firms.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials, so the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

Most builders are small firms. The majority of home builder members of NAHB build less than 10 homes per year. The majority of subcontractor firms are similarly small, although it is not uncommon for a subcontractor firm to be larger than the builders for whom it works.

In 1987, there were 1.4 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 342,000, had total receipts of $204 billion, while the 1.06 million establishments with no payroll had receipts of $34 billion. Out of total receipts, about 35 percent went toward the purchase of materials and supplies and another 7

percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that's equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 percent of their dollar volume to work done by subcontractors and 5 percent subcontracted 100 percent of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

CONSEQUENCES OF CLASSIFICATION

Reclassification of subcontractors as employees would:

1. Add substantially to the cost of doing business of the small home builder;

2. Remove the flexibility of the owner to respond to a volatile market and seasonal conditions;

3. Shift the nature of the home building business from small business to a concentration of large firms;

4. Would add substantially to the cost of housing driving thousands of protected buyers out of the market.

COMMON LAW RULES

Generally, classification of a worker as an employee or an independent contractor turns on the common law definition of "employment." In order to characterize workers, common law principles, statutory rules of workers' compensation, and employer tort liability as well as the twenty-factor test, developed by the Internal Revenue Service, must be reviewed.

NAHB believes that any limitation on the standards for determining employment would so restrict the independent contractor classification as to exclude subcontractors who, pursuant to industry custom should legitimately and properly be so classified. NAHB opposes any governmental effort to encourage businesses to classify independent contractors as employees.

SECTION 530 OF THE REVENUE ACT OF 1978

NAHB opposes any proposed elimination of the "industry practice" safe harbor. The proposal provides for the termination of this safe harbor at the time of issuance of regulations and guidance as to classification of workers in the home construction industry. This safe harbor is of direct and significant import to the building industry. Its' termination would be most harmful to businesses and regions which customarily "sub-out" to independent contractors under factual circumstances which may not satisfy the twenty-factor test or the anticipated IRS standard for "industry practice".

NAHB fully supports the proposition that every American must pay his full share of Federal income tax. It is the job of the Internal Revenue Service to resolve compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements, not through changes in the underlying law.

HEALTH INSURANCE EXPENSES OF SELF-EMPLOYED INDIVIDUALS

The deduction for the health insurance expenses of the self-employed expired December 31, 1993. Reinstatement of this provision is a simple case of equity. This provision affords entrepreneurs treatment similar to those citizens whose health insurance is paid for by an employer. The home building industry is comprised largely of small independent businesspersons, whose insurance is therefore, self-provided. NAHB has long advocated permanent extension of the deduction for health insurance expenses of the self-employed and an increase in amount to 100%.

AMERICAN DREAM SAVINGS ACCOUNTS

NAHB supports expansion of tax-deferred retirement savings and use of IRA deposits for down payment on a first home. The proposal would create a new IRA (American Dream Savings Accounts), and allow the tax and penalty-free distribution of funds from that account for first-time home purchase. NAHB supports this legislation and suggests modification of its provisions to better accomplish its stated purposes.

Accumulating the downpayment for the purchase of a first home is the primary barrier to home ownership for many young households. Even with lower downpayment requirements under FHA and special affordable housing programs from Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, first-time home buyers find it difficult to accumulate the cash necessary to make the leap into home ownership. The U.S. Census Bureau and the Harvard Joint Center for Housing Studies have recently reported that down payment remains a serious barrier to home ownership for young renters.[1] Approximately nine-out-of-ten young renters cannot afford to purchase even a modest home in their area.

Increasing housing costs add to the housing affordability problem in this country. From World War II until 1980 homeownership rates in the U.S. increased. Since that time homeownership rates overall have declined. Particularly hard hit are those in the prime home buying age of 25-34. The homeownership rates of those in the age group 25-29 dropped from 43.3% to 34.6% and those in the 30-34 age group dropped from 61.1% to 51%. This trend is of significant concern.

Homeownership Rates (Percent)

Age	1980	1983	1986	1990	1993
25-29	43.3	38.2	36.1	35.9	34.6
30-34	61.1	55.7	54.1	51.5	51.0
35-39	70.8	65.8	64.2	63.1	62.9
40-44	74.2	74.2	69.3	70.4	68.7
45-54	77.7	77.1	75.6	76.1	75.2
55-64	79.3	80.5	81.0	80.4	79.6
65-74	75.2	76.9	77.6	78.7	79.9
75+	67.8	71.6	70.3	71.0	74.0

There are many factors that contribute to the housing affordability problem we are facing in this country. Certainly a factor has been increasing housing costs. Higher mortgage interest rates and general economic inflation have also been factors. The National Association of Home Builders believes government over-regulation is a significant contributor to increased land development and housing costs. The Kemp Commission on "Removing Barriers to Affordable Housing" identified numerous government regulations that add to the problem. We strongly urge Congress to make an aggressive review of these regulations and eliminate or change those that are unnecessary, costly and counter productive.

WHY IT IS IMPORTANT TO PROMOTE HOME OWNERSHIP

NAHB urges Congress to pass the American Dream Savings Act to create an incentive which will promote savings and encourage homeownership. The American Dream Savings Act will make it possible for thousands of young working families to obtain the American Dream of homeownership. In turn, the construction of their homes will create jobs and the expansion of our economy. Equally important the expansion of homeownership contributes to the social/political stability of our society.

HOUSING - ITS ECONOMIC IMPACT

Housing construction contributes jobs, taxes, and economic activity to the U.S. economy. Each year, nearly 3 million jobs are created in the construction of new homes. These jobs create $78 billion in wages and $ 44 billion in federal, state and local taxes on that wage and business income. Even greater economic activity is created as the income generated in the construction, manufacturing, and sales jobs spread throughout the rest of the local economy.

NAHB estimates that housing, including new construction, remodeling, repairing and maintenance, and the value provided by existing homes accounts for 13 percent of the U.S. economy. This on-going benefit provides most American home owners and renters with decent, safe affordable housing.

		Single Family		Multi-family	
Industry Group	**Avg Annual Wage**	**Number of Workers**	**Wages (1,000s)**	**Number of Workers**	**Wages (1,000s)**
All Industries		2,097	$60,495.0	800	$23,297.3
Construction	$29,222	1,194	34.901.1	453	13,237.6
Onsite	29,222	1,015	29,660.3	398	11,630.4
Offsite	29,222	179	5,230.7	55	1,607.2
Land Development	29,222	100	2,922.2	50	1,461.1
Other Industries		803	22,681.7	297	8,598.7
Mfg	32,370	335	10,844.0	152	4,920.2
Trade, Transp, and Services	26,808	261	6,996.9	84	2,251.9
Mining	23,386	207	4,840.9	61	1,426.5

HOMEOWNERSHIP - IT'S IMPACT ON OUR SOCIETY

Homeownership truly is a fundamental part of the American Dream. Getting a good education, working hard, practicing thrift so that home ownership can become a reality, has been a motivating force for millions of Americans. NAHB's surveys show that 80 to 90 percent of all Americans want to become home owners. Recent studies by Fannie Mae have demonstrated the goal for home ownership is strong among all age and income groups. We believe that a goal seeking, motivated population is an essential element of a stable, productive society.

Homeownership not only allows families to establish roots in their communities, but it strengthens neighborhoods, expands participation in civic, religious, and community activities. It is what ties our neighborhoods together.

Homeownership provides financial security. It is the largest single asset of most Americans. For millions it represents a nest egg for retirement which has provided the elderly a strong supplement to social security. Many point to the low rate of per capita savings in the United States. However, if the equity in the homes of individuals were calculated, our per capita savings rates would be dramatically higher.

Homeownership also is the tax base for our public schools and community services. It provides a safe haven, a sanctuary, a secure place for families to live, grow and prosper. This environment is essential for the development and growth of our children. How can a child study properly, develop family values, excel and expand their goals and dreams without the proper environment? Homes are what provide that secure, protected and nurturing environment for millions of Americans. We should strive to do what is possible to provide this opportunity, homeownership, for more young families, and that Chairman Meyers is what the American Dream Savings Account will do.

IRA SAVINGS FOR DOWNPAYMENT

IRAs could be a useful resource to assist in first-time home purchase. IRAs already have substantial deposits. Total assets held in IRAs and Keogh plans (retirement plans for the self-employed) reached $773 billion at the end of 1992. Another $230 billion is invested in salary reduction plans (401(k), 457 and 403(b) tax deferred employer and employee contribution retirement plans) and $304 billion is invested in the federal government retirement plan for civil servants[2]. Collectively, these retirement plans could provide up to 1.3 trillion dollars.

Current Proposals. A number of proposals have been made to increase the potential use of retirement accounts for first time home purchase down payments. Proposals for use of existing "front-end" accounts typically propose penalty-free withdrawal of funds from the IRA for specified purposes. However, the tax that was deferred when the deposit was originally made must be paid at the time of withdrawal. Accordingly, withdrawal would be relatively expensive, especially if the funds were deposited at a time when the taxpayer's marginal tax rate was lower.

In this connection, we commend to your attention a bill entitled the "Savings and Investment Incentive Act of 1995", S. 12, introduced by Senators William Roth (R-DE) and John Breaux (D-LA). That bill would restore the IRA deduction and adjust the $2,000 deductible amount for inflation. It would also create nondeductible tax-free IRAs called "IRA Plus" accounts. Under the provisions of S. 12, distributions may be made free of penalty if used for first-time home purchase by the individual, their spouse, child, grandchild or ancestor.

The American Dream Savings Account (ADS) would provide an incentive to use IRA funds for a first-time home purchase. However, as currently crafted, the proposal's impact on home ownership would be minimal. The proposed ADS rules would require that the funds be maintained on deposit at least 5 years prior to withdrawal. First time home buyers are typically in their early 30s and currently have small account balances in tax-deferred retirement accounts. The long waiting period coupled with the first-time purchaser's paucity of funds defer and diminish the stimulative impact of the proposal. Although the ADS would increase the incentive to save, resulting in greater participation, the likelihood of generating substantial savings is small.

NAHB suggests that the ADS proposal be modified to allow home purchase withdrawals to be made from parents and grandparents accounts and that the waiting period be eliminated for first-time home purchase. The reason that this is important is because the very individuals this is targeted to assist, those young working families that are recently out of college trying to pay off student loans, or finance a car, have precious little left over for a retirement account.

Program Design. In designing a successful proposal for using retirement funds for down payments, there are three important components: 1) The use must be considered an alternative investment rather than a withdrawal; 2) Eligibility must be open to parents and grandparents of first time home buyers as well as the buyer; and 3) Eligible plans must include IRAs, Keoghs, 401(k) and other salary reduction plans, and the federal government retirement system. In the alternative, an attractive and economical proposal would allow down payments for first home purchase to be treated as an investment for tax deferred accounts rather than as a penalty-free withdrawal. Withdrawing the funds also subjects the taxpayer to implicit penalties in that the account holder's investments in tax deferred assets are reduced. From the point of withdrawal on, interest on withdrawn funds would be taxed at current marginal tax rates, again often higher than those anticipated during retirement. Treating the down payment as an alternative investment would avoid both explicit and implicit penalties.

The ability to use tax deferred retirement accounts for a down payment must be open to parents and grandparents because few young people have sufficient retirement savings to be useful. Table 1 shows participation rates by age of employee in employer pension plans. Table 2 shows account balances by age for salary reduction plans, chiefly 401(k) plans. Employees between 25 and 30 years old have the lowest participation rate in retirement plans and an average account balance of $5,185. A 10 percent down payment and associated closing costs on a median priced existing home sold would require cash in the amount of $13,000[3].

On the other hand, the parent of a potential first time home buyer is at least 45 years old, with an average IRA balance of approximately $16,380. Grandparent IRAs are most likely to have sufficient balances to provide down payment support in that workers between 60 and 64 years old have average IRA balances of $25,011.

Under current law, IRAs are primarily alternative forms of retirement savings when the saver's employer does not offer a retirement account, the saver is not self-employed, or the saver's income is under $40,000. About 20 percent of all workers have IRAs compared to 53 percent who participate in some employer pension plan. In order to have any significant impact, the first-time home purchase provision should also apply to other retirement accounts.

Expanding the eligible investments of a tax deferred retirement account to include qualified first time home purchases will have very little impact on federal tax receipts in the near term. The transfer of funds across investment opportunities is already a frequent occurrence and has no federal tax implications. The ability to use retirement funds for first time home buyer assistance may increase the desirability of saving in this form, both for potential first time home buyers as well as their parents and grandparents. Any increase in tax deferred savings because of the expanded options would decrease federal tax revenues over a longer period of time as deposits increased.

Table 1
Participation in Employer Pension Coverage

Age	Percent of All Workers Who Participate
25 - 30	40.9
31 - 40	53.3
41 - 50	62.6
51 - 60	60.0
61 - 64	54.2
65 & Up	27.5
All	53.3

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.5.

Table 2
Average Account Balance
Among Salary Reduction Plan
Participants

Age	Average Balance
25 - 30	$5,185
31 - 40	$10,207
41 - 50	$16,380
51 - 60	$20,456
61 - 64	$25,011
65 & Up	$13,953

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.18.

In this regard, we recommend that such use (by either the buyer, parents or grandparents of the buyer) be deemed an eligible investment of the IRA. Roughly 15 percent of potential first-time home buyers have invested in IRAs and another 9 percent have invested in 401(k) plans [4]. NAHB estimates that allowing a first-time home buyer's purchase to be a qualified investment within the plan would create 20,000 jobs and generate 36,000 additional home purchases.

CONTRIBUTIONS IN AID OF CONSTRUCTION

As the Contract with America moves towards passage, there may be some opportunity to include additional provisions in the tax package. In that event, NAHB would urge that you amend the Internal Revenue Code to remove the tax on contributions-in-aid-of-construction. NAHB considers this to be a "tax" levied on home builders and, in-turn, home purchasers.

The 1986 Tax Reform Act repealed Internal Revenue Code section 118(b) with respect to corporate regulated utilities. The tax imposed on utility companies is grossed-up and passed on to developer-builders who must increase the cost of each home to cover this cost. The additional amounts resulting from CIAC adds from $2,000 to as much as $5,000 to the cost of each home sold, depending on the area of the country affected.

MORTGAGE INTEREST DEDUCTION

NAHB would strongly resist any tampering with the mortgage interest deduction, which we maintain is the cornerstone of housing policy and the principal government policy that changed this nation from one of renters to one with 65% home ownership.

Conclusion

For the reasons stated above, the National Association of Home Builders believes that the proposals contained in the Contract with America would be beneficial to the home construction and remodeling industry. The Contract would provide much needed tax relief and begin to bring the Internal Revenue Code into accord with economic reality and taxpayer fairness. As we have stated, we suggest that certain proposals be modified to have a more meaningful and immediate impact.

On behalf of the National Association of Home Builders, I want to express my appreciation for having had this opportunity to present our views on the the Contract with America and certain other tax provisions. We look forward to working more closely with you and your staff in the coming years.

END NOTES

1. *The State of the Nation's Housing 1993*, Joint Center for Housing Studies of Harvard University and *Who Can Afford to Buy in House in 1991*, Current Housing Reports H121/93-3, Bureau of the Census.

2. Employee Benefit Research Institute, EBRI Notes, November 1993 and Issue Brief, December 1993.

3. The median existing home sales price for the first half of 1993 was $106,000 and closing costs for an FHA loan are about 2.5 percent of the mortgage amount. Hence, cash required is $10,600 for the 10 percent down payment and $2,456 for closing costs on a 90 percent mortgage plus the 3 percent up-front insurance premium.

4. "Down Payments for Retirement Accounts", Housing Economics, March 1991.

STATEMENT
on the
INCREASE IN UNIFIED ESTATE AND GIFT TAX CREDITS SECTION
in the
SMALL BUSINESS INCENTIVES PROVISIONS
of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995
for submission to the
HOUSE COMMITTEE ON SMALL BUSINESS
for the
U.S. Chamber of Commerce
by

William T. Sinclaire
Senior Tax Counsel and Director of Tax Policy

The U.S. Chamber of Commerce, representing 215,000 corporations, 3,000 state and local chambers of commerce, and 1,200 trade and professional organizations, appreciates this opportunity to express its views on the Increase in Unified Estate and Gift Tax Credits section (sec. 12001) in the Small Business Incentives provisions (Title XII) of the *Job Creation and Wage Enhancement Act of 1995* (H.R. 9).

The Chamber supports estate and gift tax reform and strongly favors simplification and an overall reduction in the estate and gift tax burden on individuals and the owners of family businesses.

Gift taxes are imposed on lifetime transfers and estate taxes are imposed on transfers at death. Gift and estate taxes have been unified since 1976 so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his lifetime and at his death. Prior to 1976, separate tax rate schedules applied to lifetime transfers and to transfers at death. Under the current unified rate schedule, gift and estate tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative transfers over $3 million.

Generally, the amount of gift tax due from a taxpayer for any tax year is determined by multiplying his cumulative lifetime taxable transfers by the applicable rate from the unified tax rate schedule and then subtracting any gift taxes that were due from him for prior tax periods. This amount is reduced further by any available unified credit to determine the final gift tax liability for the tax year.

The amount of estate tax due is generally determined by multiplying the decedent's cumulative post-1976 taxable transfers by the applicable rate from the unified tax rate schedule and then subtracting any gift taxes that were paid for post-1976 taxable transfers made by the decedent for prior tax periods. This amount is reduced further by any remaining unified credit to determine the final estate tax liability.

The unified credit is available for taxable transfers made by gift and at death. The unified credit has been fixed at $192,800 since 1987, and it effectively exempts $600,000 in cumulative taxable transfers from gift and estate taxes. However, the benefits of the unified credit and the graduated estate and gift tax rates are phased-out beginning with cumulative taxable transfers rising above $10 million, and fully phased-out when taxable transfers reach $21,040,000. This is accomplished by adding a five-percent surtax on cumulative taxable transfers from $10 million to $21,040,000. Accordingly, when a taxpayer has made cumulative taxable transfers exceeding $21,040,000, he will have an effective tax rate of 55 percent.

The unified credit was originally enacted in the Tax Reform Act of 1976. This law increased the unified credit over a five-year period to $47,000 in 1981, effectively exempting $175,625 of taxable gift and estate transfers. The Economic Recovery Act of 1981 increased the unified credit every year between 1982 and 1987. The 1987 credit amount of $192,800 has remained unchanged since that year and is the current unified credit. Effectively, the $192,800 unified credit exempts $600,000 of taxable gift and estate transfers.

The proposal in H.R. 9 would apply to gifts made and to the estates of decedents dying after December 31, 1995. It would increase the unified credit from its present $192,800 level to $248,300 over a three-year period starting in 1996. The unified credit would be $229,800 in 1996, $239,050 in 1997, and $248,300 in 1998, effectively exempting $700,000, $725,000, and $750,000, respectively, in taxable gift and decedent transfers. The unified credit would then be indexed after 1998 for inflation by multiplying the applicable exclusion amount of $750,000 by a cost-of-living adjustment. A conforming amendment would also be made to the five-percent surtax to assure a proper phase-out of the unified credit.

The proposal to increase and index the unified estate and gift tax credit is a step in the right direction. However, the Chamber encourages consideration of increasing the credit immediately and raising it even higher. If the unified credit had been indexed using the changes in the Consumer Price Index since 1987, the unified credit would be at a level in 1995 that would effectively exempt approximately $786,000 of taxable gift and decedent transfers. Not starting at that effective level for 1995 puts the small business owner in the position of having to potentially pay gift and estate transfer taxes on purely inflationary increases.

The Chamber believes the current estate and gift tax system can be punitive. It can deplete savings and family businesses and effectively punish capital accumulation and the hard work of a lifetime. Today's estate and gift tax structure can force a successful family business to liquidate or force it to be overburdened by debt incurred to pay estate taxes. Relief is sorely needed to foster growth of small businesses.

Small business makes a distinctive and creative contribution to the American economy and offers great opportunities for any American seeking economic independence. Small businesses produce a major share of business innovation and their numbers make them the largest source of private employment in America today. The

interests of small and new enterprises can be served best by an ongoing effort to have an environment conducive to their growth and continuance.

The Chamber believes increasing the unified estate and gift tax credit and indexing it for inflation is vital to their stability and fully supports these provisions in H.R. 9.

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